S. Hrg. 103–906

U.S. COMPETITIVENESS AND TRADE POLICY IN THE GLOBAL ECONOMY

NGS

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED THIRD CONGRESS

SECOND SESSION

ON

THE CHALLENGES POSED BY THE INTEGRATION OF WORLD CAPITAL MARKETS AND HOW THE UNITED STATES SHOULD RESPOND TO THOSE CHALLENGES

SEPTEMBER 21 AND 28, 1994

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

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U.S. COMPETITIVENESS AND TRADE POLICY IN THE GLOBAL ECONOMY

WEDNESDAY, SEPTEMBER 21, 1994

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
Washington, DC.

The Committee met at 10:10 a.m., in room SD–538 of the Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN DONALD W. RIEGLE, JR.

The Chairman. The Committee will come to order. Let me welcome all those in attendance today.

In starting today's hearing, I want to put this hearing's very important discussion of American competitiveness in an historic context with respect to the work of this Committee over the last several years.

It was nearly 6 years ago in July 1989—5½ years ago—that the Banking Committee here conducted the first of what have since been nearly 40 hearings in this Committee room during my Chairmanship to look at the issue of the American competitive position in the global economy.

At that very first hearing, which laid the foundation for these now over 40 hearings that have occurred, I said the following, and I quote:

> Over the years, I along with many others have become increasingly concerned about the competitiveness of many of our most important industries, and more generally about the ability of the United States to compete effectively in the international marketplace. This has important ramifications not only for our standard of living but also for our national defense and our long-term economic and military security. This topic will be a dominant theme of the period of time of my Chairmanship, and it is my intention to hold a comprehensive set of hearings on these issues.

Since then, the Banking Committee has conducted extensive hearings on a bipartisan basis, with the cooperation of Senator D'Amato and before that Senator Garn, to examine various facets of America's position in the world economy.

We have had now over 100 distinguished witnesses who have appeared before us. They include, of course, the chairmen of many major American corporations, such individuals as Donald Petersen, then chairman of Ford Motor Company; Stanley Pace of General Dynamics; Robert Galvin of Motorola; Charles Corey of U.S. Steel; Rand Arisgog of IT&T; and Norman Augustine of Martin Marietta. The Committee also invited several Nobel Prize economists to testify, such as Paul Samuelson and Lawrence Klein. Former Fed Chairman Paul Volcker; John Reid of Citibank; and Bob Ruben

who now is head of the National Security Council but who at that time was Chairman of Goldman Sachs also testified. In addition, Frank Carluci, Former Defense Secretary, Jeff Garten back again today, who is now the Under Secretary of Commerce for International Affairs; and Laura Tyson, at that time a distinguished academic leader, and now, of course, Chairperson of the Council of the President's Economic Advisers. We have had a broad, much longer list of business leaders, economists, and financiers from across the country.

I would say that the most consistent theme of the testimony presented at those hearings was that America's industrial and technology base had declined in relation to our foreign competition, and that our international financial standing had weakened as well.

Such slippage, we were told, has enormous implications for our standard of living and for our national influence, and I think, in fact, in the end for our social order.

I believe our economic strength is a precondition for having the kind of peaceful and upwardly mobile society that we want to see.

Large trade deficits, we were told, were one sign of our competitiveness problems and, obviously, help make other problems worse than they otherwise might be.

Based on testimony presented during these hearings, the Committee, again on a bipartisan basis, went to work to develop several pieces of legislation that were designed to actually strengthen America's industrial and financial base and our international trade position.

Among the major legislative initiatives that came out of this that have now become part of the fabric of law are the Defense Production Act Amendments of 1992, the Export Enhancement Act of 1992, and most recently, now on the President's desk waiting for his signature, the Interstate Banking and Branch Efficiency Act of 1994. There are many others.

Another bill that was developed by the Committee, that has not yet been enacted into law due to jurisdictional problems in the House, is the Fair Trade and Financial Services Act, but we are, I might say, still working on that even at this moment.

The Export Enhancement Act of 1992, which Senator Sarbanes did so much to fashion, reformed our country's export promotion and financing programs. Included in that legislation was Section 206, which I wrote into that bill, which requires the Secretary of Commerce to prepare an annual report on U.S. export competitiveness, and to appear before this Committee to testify on it.

This provision was designed to keep a continued focus on America's ongoing massive trade deficits and the need for coordinated technology and trade policies that would continue to strengthen our international competitive position.

Mr. Secretary, the report you have presented to the Committee today entitled "Competing To Win In A Global Economy" is a very important report. It is evidence of the seriousness with which you and the Clinton Administration treat the subject of our international competitive position.

You accurately state in the report's introduction: "There is no more important subject. The changing world economy now affects

every area of our lives. Our trade, our capital markets, our jobs, and our communities are linked to conditions and policies abroad."

I know you have been leading a number of high profile trade missions to areas around the world to try to find new markets for our products to grow the American job base and make our economy more vital.

I am 56 years old, and I might say for those of us in my generational time slot that we grew up at a time in America where the global situation was such that we did not have to worry quite so much about whether there were going to be jobs for ourselves or, looking down the line, what we hoped would be job opportunities for our children.

But the changing world economy has brought a rapid shift in circumstances, and today in almost every community whether it is a rural community, a farming community, a metropolitan or industrialized urban community, the entire fabric of economic life is now connected to this global economy, whether we like it or not. The adjustments that come with that are very difficult, and it is important that we understand them and have the best possible strategies to deal with them.

I would say that, despite the best efforts of this Committee, and the Administration generally, to strengthen America's competitiveness, yesterday's trade figures show exactly how tough this problem continues to be. Our July trade deficit was over $11 billion, which if projected out on an annual basis would be up over $130 billion annually. Our July deficit with just one country, Japan, was $5.7 billion. Now imagine $5.7 billion of capital running out of the country in 30 days just to one country, one trading partner, as it did in the case of Japan.

The situation with China is also very serious. We had a trade deficit with China in July of $2.7 billion. With Europe, it was a figure of $2.4 billion.

I do not think we can continue to have a situation that runs indefinitely where these kinds of very large deficits continue. That is precisely why this Committee has devoted so much time and effort over the past 5 years to move into as many areas as we could to change the strategies and the pattern of law to try to deal with this situation.

This will be the last hearing on competitiveness that I will Chair.

I think it is critical that we continue to move down this track to make sure that we do not lose our focus on the question of what we are doing to drive America into a number one competitive position in all the areas that relate to our standard of living and to our future.

I hope the Commerce Department continues to reflect the quality and the commitment of what I found in this report today in future reports. I think that will be one of the most hopeful signs of the fact that we are making every effort to turn these negative trends around where they exist, and to move into the strongest possible position looking ahead into the future.

Mr. Secretary, I want to say how much I appreciate your efforts. I know the people of Michigan, many of whom find their livelihoods depending upon the success of your efforts in leadership at the

Commerce Department, appreciate the energy and the focus that you have given this.

This Committee wants to help you in every way we can, and we look forward to your statement here this morning.

Senator D'Amato.

OPENING STATEMENT OF SENATOR ALFONSE M. D'AMATO

Senator D'AMATO. Thank you very much, Mr. Chairman.

As this is going to be the last time you chair hearings as it relates to this important issue, let me thank you for all the work that you have done in focusing in on our efforts to be more competitive.

Mr. Chairman, I am going to ask that my full statement be included in the record as if read in its entirety.

The CHAIRMAN. Without objection, so ordered.

Senator D'AMATO. First, I would like to take this opportunity to thank the Secretary for moving as quickly as he has in responding to a request that I made to him in June asking for support of an Export Assistance Center, an EAC, that New York has been designated as the Regional EAC.

We thought that the Trade Center would be the place to have it located. The World Trade Center decision has not been made as of yet, but designations for a Regional Center in New York have been made for subdivisions throughout the State at Albany, Westchester, Long Island, and Harlem.

I applaud the Secretary for moving so expeditiously and look forward to that Regional Center being established at the World Trade Center.

Second, Mr. Chairman, I have always felt, and have been criticized by those in the business community, that we have not been nearly assertive enough as it relates to our trading practices and the abuses that American companies and the American citizens have had heaped upon them as a result of unfair predatory practices that some of our partners, our trading partners, have engaged in systematically.

This has been a situation that has been with us for many years. This has been a situation in which I believe that the Reagan Administration and the Bush Administration have not been nearly attentive enough to.

I have heard admonitions that even if we insisted on fair play—and I am talking about fair play; equal treatment—that we might subject ourselves to horrible economic situations because various countries would not participate in buying our paper when we went to market to borrow, thereby creating horrible imbalances.

Imagine that you can't even ask that the law be applied fairly—existing laws—but that one of our trading partners would not participate and would hold back in the purchase of U.S. Government obligations, thereby making it more difficult to run the country and running interest rates up.

Now this has been told to me by responsible people. Are we being blackmailed into a situation of acquiescence?

I will say this: That for all of the disagreements that I have had and maintained with the Clinton Administration, I want to commend them for attempting to bring some balance to the law, and

sitting down with trading partners and insisting that they do what is right.

It is not good enough to let anyone do whatever they want at any point in time and break the law systematically, deny us the opportunity to compete in foreign markets, whether they be our fiber optics products, our construction, our engineering, the talents that we have, our financial institutions, and yet for the sake of something to say that, well, because they will flood us with cheap products or cheaper products, notwithstanding their predatory pricing, et cetera, notwithstanding that their markets are kept off, that somehow we have to look the other way.

I have to tell you that if you think that the average American gets angry, gets annoyed, does not understand, you are absolutely right.

The fact of the matter is: If you have enough high-priced fancy lobbyists making tens and tens of millions of dollars literally coming in and exercising influence over Republicans and Democrats, over Democratic Administrations and Republican Administrations, then we are selling out the birthright of this country.

It is ridiculous!

I say that because that has been the history of things.

When you try to correct the situation, what happens is everybody runs and screams and yells and carries on.

I do not have to tell you that Mr. Kantor, as far as I am concerned, in attempting to see to it that the law is obeyed and that our laws are followed through, is doing the right thing.

Look at the headlines in The Wall Street Journal: "U.S. Trade Gap Grew in July $10.99 billion."

Now some of that can be explained because they say the airplanes—our sale of planes, exports abroad, took a drop. We had a big sale last time, but the fact of the matter is that if you look at the trends, as Senator Riegle has indicated, this trend is trending the wrong direction.

It is increasing with too many of our trading partners. Too many of our trading partners are practicing the kind of discrimination against our products, our services, our goods that is absolutely unlawful and certainly immoral and not justified.

Now, by gosh, it is easy to send troops some place, and it is a heck of a lot different because you can see where you have an enemy and where you have a threat, whether it is a Saddam Hussein or whether you are standing up for Democracy. You can understand that.

But I have to tell you something, when we have the kind of thing that is taking place where we are denied our opportunities to sell our products systematically—regularly, when we run into nothing but regulatory jumble, et cetera, when we run into patents that are being stolen regularly so that we are afraid to move into areas, et cetera; when we run into these kinds of things and our markets are open, and more than open—we are being dumped on, taken advantage of, et cetera—then it is time for this country to stand up.

I have to tell you something: I applaud the effort that has been undertaken.

I encourage you not to back down, not to let the publicists who place their ads and do the rest of it, and all the media of America

who will come in—and, boy, I have to tell you, they are some of the best-coordinated; you can't even ask for fairness without being attacked as trying to stop or endanger our relationships with our Allies.

Well, if you have a good Ally, let them be a good Ally. Let them be a fair Ally.

I applaud our efforts in seeing to it that the laws are adhered to.

Yes, I do not want to be against free trade, but I do not think free trade should operate one way. I do not think free trade should mean that our Allies take advantage of us.

I have not mentioned any nation specifically lest I be accused of bashing, but I will say to you that if the shoe fits, wear it. And to the journalists who come up to me afterwards and say, well, Senator, who were you talking about? For God's sake, you are smart enough to look at the record. Look at the record and see!

I tell you, it has been going on for far too long. We have literally allowed our birthrights to be sold out, and it is continuing to be sold out on the altar of the high-priced lobbyists who have too much influence—too much influence—with too many people in too many Administrations over the years.

I hope that you, Mr. Secretary, take the big picture and do not allow this to continue. See to it that there is fairness.

We want open markets.

We are not looking to exclude people from coming into our markets, but we have a right, because we are competitive. We are producing cars better, cheaper, and faster. We now are having countries come in and put their assembly plants here in the United States as proof of that.

We have, in terms of our competitiveness, moved incredibly, eons, in the past several years. Now we still find that the balance moves against us, the trade balance. That is wrong. That is absolutely wrong.

Unless we begin to insist on fairness, we are going to have a breakdown here that no one will be able to sustain. I cannot see a great nation being held hostage by people saying, woah, watch out, they will not buy our paper. There will be trade wars.

If a trade war must come because we are insisting on fairness, I would rather have it now than when we are in a more weakened position. I would rather get it out and face it and confront it now and put it out on the table so that all could so.

I think that the Administration has been very tolerant. I do not think taking an action on flatware glass is going to be the answer. I think it has to be more comprehensive.

I have to tell you, you are nibbling at the edges. This does not send—and I applaud you for doing more than the past Administration who just put its head in the sand.

So that is my statement. Obviously my experts did not write it. [Laughter.]

The CHAIRMAN. Thank you, Senator D'Amato. You have gotten me steamed up. I may have to make another opening statement myself right now.

I will say before calling on Senator Boxer that if you take just the case of our trading relationship with Japan where we have fo-

cused our efforts to try to deal with some of the trade unfairness and the barriers to our products here and so forth, our deficit with Japan in 1 month, July, was $5.7 billion. That is despite the fact that the dollar is much cheaper, and therefore makes our goods more competitive.

One would think that if the normal laws of economics were working, we would be bringing that deficit down quite sharply, or maybe even moving into a surplus position with Japan. But I think the shift in currency, which is not helping us like it should, shows us that there are ingrained problems—I think predatory trading practices of various kinds built into the relationship—that are really hurting this country.

Let me now ask unanimous consent to put Senator Dodd's statement in the record at this point and yield to Senator Boxer.

OPENING STATEMENT OF SENATOR BARBARA BOXER

Senator BOXER. Thank you very much, Mr. Chairman.

I am glad that Senator D'Amato made his points because I think we can all agree that we must be tough and we must fight for our rights.

Let me say, Mr. Chairman, once again because whenever I get the chance, I do want to thank you for your leadership on this Committee. You have always been there on the cutting edge of all the issues that are important to working people, to business, and I just for one want to put that on the record once again.

The CHAIRMAN. Thank you.

Senator BOXER. I want to say to our Commerce Secretary for whom I have the highest regard and praise, that I am really glad you are there because this is tough, and these are difficult times.

We are in a transition economy, and no one knows it, I think, better than those of us in California who have had to move from a defense-based economy to a civilian-based economy.

You have been very helpful to us in that, whether it was the one-stop shop to give people information on defense conversion, or making investments in new technologies, given the difficult deficit reduction times that we are in.

It is very easy to do that when we have the money to spend but it is more difficult in tight budgetary times.

I would like to say to Senator D'Amato that he should feel good about the Commerce Department report. On page 37 you talk about the fact—actually it starts on page 36—trade law enforcement, and you say that you are going to be vigorous, and you say the Department is committed to the vigorous enforcement of the laws and implementation of the changes negotiated in the Uruguay Round.

Again, just on some of the points that Senator D'Amato made, in California with NAFTA we are having trouble getting some of our produce through in Mexico. They are figuring out ways to hold up the produce. First they found a bug. Then, they really didn't find a bug. Then they said the truck could not go through. It did not have the right license. All of the things that some of us thought could happen, some of it is happening.

On the bright side, Ambassador Kantor is outraged about it and he is getting down to work about it. So it is true. Even with our good friend Mexico we are having some of these problems.

So the message I guess you are hearing from us is: Fight on. It is very important.

In the early part of your report, in your letter, you say: "We recognize the primacy of the private sector in creating economic growth. Government's role is to work with industry, labor, and academia to create a healthy, sustainable foundation on which U.S. companies are able to compete and win in the global economy."

I think that is exactly right, that Government must be a partner. We cannot shrink from that because, guess what? It is going on in other countries. We cannot possibly expect our products to have the kind of acceptance if Government is not a partner in this.

You paint Government as more of a silent partner. That is fine. When we can be silent, we will. But you also have to get on those planes and go to other countries to push American export, and, I am so proud to see you out there doing that. I think it is patriotic to do it because we are the best, and we do have the best workers, and we are the most competitive.

So I want to encourage that. My State of California is on the Pacific Rim and our future is absolutely interwoven with the global marketplace.

Your success will be our success in California, and I want to applaud you for taking this broad view, but yet getting the results we need and to encourage you, as the other Senators, have done to stay tough.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator Boxer.

Mr. Secretary, we are delighted to have you. We would like your statement at this time.

We will make the report you are presenting today a part of the record.

STATEMENT OF RONALD H. BROWN, SECRETARY, U.S. DEPARTMENT OF COMMERCE, WASHINGTON, DC

Secretary BROWN. Thank you very much, Mr. Chairman, Senator D'Amato, and Senator Boxer. It is a pleasure for me to be with you this morning.

I want to applaud all three of you for the statements that you made. They very much represent the essence of the testimony that I am about to give and of the work that we have been doing at the Commerce Department.

I am pleased to be here to present our second annual report on the International Competitiveness of the United States. I am particularly pleased that it is a good news report.

Obviously I want to thank you, Mr. Chairman, for the leadership that you have provided this Committee through the years particularly on this subject—the subject of American competitiveness.

I know that Senator Sarbanes and others have worked as partners in this effort. I certainly know of the work and interest of Senator D'Amato and Senator Boxer and other Members of this Committee as we have tried to focus our country's attention on the challenges of competitiveness.

For many years this Committee has held hearings on this critical subject, and I want to commend you for your foresight and perseverance.

It was not many years ago when you talked about competitiveness and folks kind of looked up to the ceiling. They did not know what we were talking about.

Now I think more and more people in our country understand the critical nature of our being a more productive and a more competitive Nation if we are going to continue to be able to grow this economy and to create high wage, high quality jobs for the American people.

Last year I was able to tell you primarily of the challenges faced and the initiatives that we planned. This year I am pleased to report a record of solid accomplishment as well as progress made toward pursuing our opportunities in the global market, and tackling some of our fundamental economic problems.

The bottom line of our report is simply this: Although daunting challenges remain, our economy is back on track and our prospects in the global marketplace are indeed very bright.

As Vice President Gore has been known to say in recent months: What should be up is up; and what should be down is down.

Private sector job creation and economic growth are up.

When President Clinton took office he pledged to create 8 million new jobs during the first 4 years of his Presidency—those jobs obviously were to be created in the private sector where they belong. Under his leadership, over 4 million jobs have been created in 1½ years. That is 1.7 million more than were created in the 4 previous years.

The United States economy as measured by the real gross domestic product grew at 3.1 percent in 1993, and at an annual rate of 3.3 percent in the first quarter, and 3.8 percent in the second quarter of this year. Since January 1993 this growth rate has been more than three times the average growth rate in the period between 1990 and 1992.

Unemployment and inflation are down. The unemployment rate has fallen from 7.7 percent in June 1992 to near 6 percent today.

Despite the strong recovery, consumer prices of goods and services have increased only 2.6 percent over the past years, and producer prices are up only slightly.

Compared with other major industrialized nations, the United States is in better shape than it has been for a long time.

The United States standard of living remains the highest. The United States unemployment rate is the lowest, except for Japan. And since the beginning of this year we have outpaced all others in creating new jobs for our people.

The United States budget deficit is among the lowest share of GDP. Many of our industries—autos and semiconductors and machine tools for example—are recapturing market share lost in the previous decade.

This good news is no accident. It has been driven by the Administration's success in reducing the Federal budget deficit and by new Administration initiatives, including those I am proud to say, that have been undertaken by the Commerce Department in the

fields of technology, trade and export promotion, economic development, and sustainable development.

The good news notwithstanding, fundamental challenges do remain. Our national savings remain unacceptably low. Net fixed investment in the 1990's is much lower than in the previous decade. The labor compensation gains have been low. A long-term trade imbalance, as was indicated by Senator D'Amato and others, remains. Educational performance remains a concern at the secondary school level. Health care costs are the highest in the world. So we do have some problems.

The report also emphasizes this Administration's belief that competitiveness must be viewed in the broadest possible terms, encompassing not only trade policy but technology, savings and investment, education and training, the health and safety of our citizens, and the cohesion of our communities.

The Department of Commerce is deeply committed to helping American companies become more competitive in the global economy. As we are proving every day from the Pacific Rim to Latin America to the European Union, American workers are, in fact, the most productive workers in the world.

American product services and technology are in increasing demand in every corner of the globe. We are not afraid to compete with anyone either at home or abroad. Rather, our private sector welcomes the opportunity to compete. It is the private sector that drives the engine of economic growth and job creation.

Government's role is to work with industry, labor, and academia to create a healthy sustainable foundation on which the United States companies are able to compete and win in the global economy.

The report I am presenting to you today, Mr. Chairman and Members of the Committee, highlights initiatives that must be maintained in areas where additional efforts are needed if our country is to improve the competitiveness and standard of living of our people.

Let me briefly highlight a few of these initiatives:

First, we are determined to continue budget deficit reduction, to expand the pool of savings, and to increase investment.

Second, passage by this Congress of the strengthened and expanded trade rules achieved in the Uruguay Round is critical to 21st Century competitiveness.

We are working to expand our export promotion efforts to boost American exports and to boost high-wage jobs for the American people. We are doing this with a particularly intense focus on what we call the "Big Emerging Markets of the World."

We will strive to continue the shift of Federal R&D priorities toward a 50/50 split between civilian and defense technologies.

We will implement focused policies that promote and support further development of the National Information Infrastructure, our telecommunications superhighway, by the private sector, including passage by Congress of the Telecommunications Reform legislation that we believe will promote competition and expand the telecommunications marketplace.

We are working to enable small- and medium-sized manufacturers to compete through a national network of Manufacturing Extension Centers.

We will be seeking to improve productivity through health care reform, welfare reform, and crime reduction.

We are developing a national tourism strategy through such activities as a White House Conference on Travel and Tourism which is scheduled to take place in November 1995.

Finally, we intend to continue expansion and improvement of education and training programs. To be competitive, our work force must be adaptable.

Recently a private sector study conducted by the International Institute of Management Development and the World Economic Forum ranked the United States as the world's most competitive Nation. We ought to be very proud of that ranking.

For the first time in a number of years we have been ranked number one. We believe that the Commerce Department's policies and programs support the Administration goals of strengthening America's performance in the international and domestic marketplace, raising standards of living and creating more and better paying jobs for the future.

Our Department's strategy is to help create the environment and help create the tools to facilitate productive activities in the private sector in five related areas: civilian technology; trade; economic development; sustainable development; and tracking United States economic performance which are the subject of Part II of the report.

Let me provide you with a brief overview of our recent activities in these areas:

First in civilian technology: Technological advancement is imperative to our economic growth. Rapid and continuous improvements in products and the techniques of manufacturing and bringing them to the marketplace more efficiently are now what gives businesses and nations a critical competitive edge.

The Clinton Administration has adopted a new technology policy to support the development and commercialization of civilian technology. We have launched the Technology Reinvestment Project and expanded the Advanced Technology Program designed to spur industry's development of high risk, high payoff commercial technologies. The ATP has been expanded from a pilot program in 1992 to a national program today.

In addition, we are establishing a national network of manufacturing extension centers to assist small- and medium-sized businesses to modernize and become more competitive. Like the Agricultural Extension Services devised at the beginning of the Century, our manufacturing centers bring technology to those who need it but who otherwise may not be able to get it.

That really speaks to our work in creating a national information superhighway. We want to assure you, Mr. Chairman and Members of the Committee, that in so doing we do not create a society of information "haves" and information "havenots," but that information and knowledge is broadly available to all the American people no matter where they might live in this Nation, and no matter what their economic standing might be.

In the area of trade, a key component of enhanced competitiveness for the United States and our workers is the maintenance of an open trading system.

The Department's efforts are directed to three strategies: Market-opening initiatives; enforcement of trade laws; and export promotion.

I could not agree more with the concerns that Senator D'Amato expressed. If our markets are open to the goods, products, and services of other countries, then the markets of those other countries ought to be open to our goods, products, and services and we commit to work aggressively, and proactively with a results-oriented approach. We are really talking in terms of measurable and monitorable results.

How do you know if you are making progress if you are not able to measure that progress?

We are going to continue to be consistent in that approach. Commerce has worked vigorously with other agencies of the Federal Government to achieve greater market access for American exporters.

The Uruguay Round will create enormous potential for world trade and economic growth through tariff reductions, extension of GATT rules to intellectual property, and services- and trade-related investment measures, and improvement in the trade rules.

I would like to underscore, Mr. Chairman, the critical importance of passing the GATT legislation this session. Here we are, the Nation that through our leadership helped to break a 7-year log jam to be dragging our feet and not moving on GATT this session I think would send a very, very bad signal to the rest of the world and to our trading partners.

I would urge, Mr. Chairman, that through your leadership and the leadership of others in the U.S. Senate, that we move expeditiously on that ratification and its implementing legislation.

The Department is an important participant in numerous regional activities, as you know, Mr. Chairman, spanning the globe from Mexico, to Europe, to Japan, to the Middle East.

We have also identified key countries with maximum opportunities for the growth of American exports. We call them the Big Emerging Markets. They are particularly prevalent in Asia and Latin America and provide a new focus for our commercial policy efforts.

The Department is committed to the vigorous enforcement of the anti-dumping and countervailing duty laws and implementation of the improvements to these laws negotiated in the Uruguay Round.

Unfair foreign pricing, those practices, and Government subsidies distort the free flow of goods, adversely affecting United States business and they reduce the ability of American firms to compete in the global marketplace.

The Trade Promotion Coordinating Committee, which I have the honor to chair, has proven an effective forum for dramatically improving Federal cooperation and launching new interagency trade promotion initiatives.

I commend your leadership, Mr. Chairman, in spearheading the legislation creating this Interagency Task Force through the Congress.

I look forward to returning to this Committee in a few weeks to present you with our second annual report detailing our successes in implementing the National Export Strategy.

Economic growth is, of course, not uniform among the parts or the people of this Nation. That is why an important responsibility of our Department is to provide assistance to those communities and businesses bypassed by the process of economic change, or that have suffered economic dislocation as a result of economic change. Such efforts strengthen our Nation's competitiveness by helping all segments of our economy to grow and prosper.

I recently announced the Competitive Communities Program, an aggressive plan by the Economic Development Administration designed to support local efforts to build support and attract competitive businesses in economically distressed urban and rural communities.

In addition, we are beefing up our Minority Business Development Agency. We will soon be coming to the Congress urging an effort to codify MBDA. It now operates under Executive Order and, therefore, does not have the reach or scope we believe it should have. We believe that minority business development and minority enterprise can be an important key to our economic future.

The Department has an important role in simultaneously stimulating economic growth and advancing environmental stewardship. Recognizing this, I believe that I am the first Secretary of Commerce to place the mission of Commerce to ensure and enhance economic opportunity for all the American people within the context of a sustainable development.

In doing this, the Department works with other Federal agencies, including the Departments of Energy and Interior, and the Environmental Protection Agency, and with partners outside the Executive Branch, to advance the shared goals of sustainable development.

Both business and Government depend on critical data to plan and implement efforts to become more competitive. Efforts are currently underway, Mr. Chairman, throughout the Economics and Statistics Administration to improve the coverage and quality of reporting United States economic conditions and international competitiveness.

For instance, the Census Bureau is greatly expanding the collection of data pertaining to the rapidly growing services' industry. In addition, the Bureau of Economic Analysis is modernizing its National Economic Accounts with one aim being to make our accounts more comparable to the accounts of other industrialized countries.

Let me say this in conclusion, Mr. Chairman: With opportunities expanding all around us, we recognize the challenge of making certain that all of our citizens benefit from our progress in the world economy.

As this report makes clear, there is still much to do. We face great challenges in boosting our investment levels and improving our secondary education systems, in training our workers, and in opening foreign markets. But America is on the move again in the world economy. In the first 18 months of the Clinton Administration this has been abundantly clear, and we should be proud of our achievements.

I look forward to working with you and other distinguished Members of your Committee, Mr. Chairman, to assure that as our economy grows and prospers that growth and well-being can and will be shared by all the America people.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you so much for the comprehensive nature of your presentation today. I want to come back to it in just a moment.

I am going to yield first, though, to Senator Boxer who has a question that she wants to raise, and then she must leave for another commitment.

Senator BOXER. Thank you so much, Mr. Chairman.

Mr. Secretary, I want to encourage you and the Administration on your efforts to open up the Japanese market to exports of United States-made medical devices. I want to underscore how important this is to California, and I want to tell you about one specific case just to demonstrate it.

California's medical device industry employs nearly 40,000 workers and contributes $6.3 billion in sales to the economy.

Japanese government barriers to procurement of California's world-class medical devices is costing California companies sales and real opportunities for growth and job creation, and I am sure this is true in other areas of the country.

I want to give you a specific example.

Biomagnetic Technologies, Inc., or BTI, is a California company that manufactures a state-of-the-art diagnostic imaging device. BTI has identified millions of dollars worth of medical device purchases that the Japanese national universities and hospitals would make if it were not for the Japanese government's barriers to procurement of these devices. These barriers are unfair.

I must point out that no one in Japan makes this product right now; yet, they are keeping it out. So we are losing out because of these barriers. We could lose our competitive edge because these companies should be making profits on these sales and reinvesting those profits back into more cutting-edge technologies.

I would appreciate, Mr. Secretary, if you would tell us about the talks that are currently going on, I believe, on this very matter. If you would, let this Committee know how committed you are to fighting for this type of market access—because to us it is not just theoretical, it is very real.

Secretary BROWN. Thank you very much, Senator Boxer, for illustrating by the specific situation relating to a California medical device company.

The fact is we are faced with barriers. We are faced with barriers with Japan. There is no doubt about it. Those markets are not open to American goods, products, and services.

As I indicated a moment ago, we have been very consistent in our approach and very aggressive and proactive in our approach, and we will continue to use that strategy. We think it is the only strategy that can work. We have to insist that markets are open to American goods, products, and services. As you know, the framework discussions are going on.

There is a crucial date coming up at the end of this month, September 30th. There are still a few days left.

Our experience in negotiations generally with Japan have been that progress is not achieved until the very end of those negotiations. But we are pleased a dialog is taking place.

I have had the opportunity to talk to MIDI Minister Hashimoto. Ambassador Kantor has engaged in conversations with him, as well. His deputy arrives in the United States today for further discussions. So my attitude is that as long as there is dialog and discussion, there is opportunity for progress. We remain hopeful that there will be progress.

Our trade relationship and other aspects of our bilateral relationship with Japan are very important to us. Japan is an important trading partner. We will not allow the importance of our relationship, though, to deter us from being very forceful and very direct in insisting that steps be taken to open markets.

I cannot say that there has been great progress thus far in the discussions. There has been some. We are hopeful that there will be significant progress in the days ahead and that we can make some good announcements at the end of this month, but only time will tell.

I can say this, Senator Boxer, that we are working as hard as we can, and are being as direct and as forceful as we can in insisting on market opening measures, and insisting on a good-faith effort on the part of those with whom we are negotiating to make the kind of progress that is necessary.

There is no question that a $60 billion annual trade deficit which is rising, by the way, is unacceptable. It would be irresponsible for any Administration to sit on its hands and do nothing in the face of those facts. Clearly this is an Administration that is not sitting on its hands and doing nothing. We are working hard. We are going to continue to work hard, and I remain hopeful that we can make progress.

Senator BOXER. If I might conclude——

The CHAIRMAN. Sure.

Senator BOXER. You know, I have been on two trade trips to Japan when I was in the House, one with the Budget Committee Chairman, and the other with the Ways and Means Committee Chairman.

They are very interesting, these trade trips to Japan, because there is a lot of talk. Yet, it is hard to pin it down. Hard to see solid results. But, as you point out, you are looking for measurable results. I think we were successful when we demanded that with our computer chips. We said, it will be this many, and this much, and so on!

I would just urge you—and I know you and I know that you agree with this—that we not really leave the table until we have that answered. Because to just talk does no good.

As you well know, Mr. Secretary, the future of our country depends on this. It is the markets abroad. I want to be able to help you. I have been very—I was very skeptical on NAFTA. I still worry, and I consider myself somewhat of a NAFTA watchdog. I do hope it will be successful. No State stands to benefit more than my State.

We have an important relationship with the Japanese. I want to maintain it. It is crucial not only for the trading relationship but

also national security. We are inextricably tied together, but we need to be as tough as we can be and ask for measurable results.

I guess that is my message to you, and I hope you will keep me informed about these particular talks.

Secretary BROWN. Absolutely, Senator Boxer, as we will other Members of the Congress.

Let me just say in an unequivocal fashion that we are going to continue to fight for open markets; that we believe in free trade. We also believe in fair trade.

You cannot have global free trade unless you have open markets. That is what free trade is all about. We are going to continue to fight to lower tariff and nontariff barriers, as was certainly the case with NAFTA and the Uruguay Round of the GATT.

We are on a course. We believe we have been consistent in our approach. We believe we have demonstrated our seriousness of purpose in pursuing those goals.

Senator BOXER. Thank you.

The CHAIRMAN. Thank you, Senator Boxer.

Mr. Secretary, I started out today by putting an historic context around your appearance today and this report. I want to fill that out just a little bit more, because we are really making a major turn in direction in this country. If we do not talk about it in a focused way, we may not understand what is happening here. I want the American people, our economic leaders in society, and the press to understand it.

Representing Michigan we have certainly seen in the automobile industry and in the industrial base the tremendous impact of a globalized economy. We have seen it in terms of fair and unfair trading practices, huge recessions, unemployment, and all the problems that go with it.

We are doing pretty well in that industry right now, but nothing lasts forever. So it is essential that the foundations of our national economy be supportive of continued growth, not just in the industrial base but more broadly.

Back in 1980 when the Democrats lost control of the U.S. Senate, we began to have annual meetings where the Democrats would go off to a place near Washington to sit down and think about the future. We were not running the Committees of Congress at that time, so we had a little more time to think about what was happening.

Senator Byrd, who at that time was in charge of the Democrats in the Senate, asked me to put the program together for one of those conferences of Senate Democrats. In doing that, I decided the competitiveness of the United States was really a critical issue. So I centered that meeting around that issue—as I have done in this Committee since I became Chairman in 1989. But where are we now?

The Government cranks out a lot of documents, and a lot of them are not worth much, quite frankly. But as I look at this report, in my view this one is worth something because what you have here is an articulated strategy of partnership between business and Government and labor, and really our education system as well, to make a series of adjustments to improve our overall national per-

formance level so we can compete effectively in this international economy.

We are making progress, but underlying problems still exist which are laid out here page by page as you go through this report. But this is the first time that I have seen where the Federal Government has taken the lead with the private sector to think aloud about, and map out what I would call a "Team America" strategy.

That is really what this is. I do not say it is completely finished. It is a work in progress because we have a very dynamic situation out there. But for the first time in one place there is a coordinated vision and articulation of what the challenge is and how we ought to meet it, and what the pieces are of the solution to our national performance shortfall. And they are laid out here.

Now getting them done, whether it is in elementary and secondary education, in technology development, or in defense conversion, we have to be working in each area. There has to be something that pulls us together. There has to be some overall strategy. It is very hard to do that in our economic system.

I came here as a Republican 28 years ago. I changed my Party affiliation after I was here 6 years, as you know. So I have lived in both Parties, in both the House and the Senate, and I have listened to the articulation of economic strategy by both parties. I have seen the Congress work on it. We have worked on it in here on a bipartisan basis. Government does not have all the answers. The private sector does not have all the answers. But I will tell you this: It is so clear to me that I am prepared to leave here now at the end of this year that if business, Government, and labor do not work together in the Team America strategy, we cannot succeed.

The rest of the world will grind us up, one way or the other, because we just will not have the degree of performance, efficiency, and speed of instructive change that we have got to have unless we have that partnership.

I congratulate you for helping to spearhead that. The Commerce Secretary really is the person in our Government, I think more so than anyone else, who has to have that large economic vision.

You are the first Commerce Secretary in my mind to see it the way I think it needs to be visualized. That means no disrespect to others like Malcolm Baldridge who brought great talent and commitment to that job, or others. But to understand the criticalness in terms of holding our society together in the end, that is a whole different level of commitment and orientation that we have to have.

I am convinced that one of the biggest threats to our country right now is what I see as the shrinking of the middle class. People are sliding out of the middle class. One of the things that the report does not address adequately in my view is the fact that, while we are getting a lot of job growth, a lot of it is in low-wage jobs, part-time jobs. There are a lot of families now where both mother and father are working two jobs each. They have, between them, four jobs. They are never home. The kids are latchkey children because the family is struggling to try to earn enough overall income to be able to pay the rent, buy health insurance, etc. Most of the part-time workers do not get health insurance, and a great number of full-time workers do not get it, either, through their employer.

So we have a problem where the middle class is under tremendous pressure.

I think the Administration deserves great credit for deficit reduction, job growth, low inflation, and so forth. But there is still this great sense of unease among a lot of people who either want to be in the middle class and cannot get there, or who are there and feel like they are sliding backwards.

But I think part of why people may not appreciate some of the accomplishments of this Administration is that there is still this profound sense of economic uneasiness for so many people in our society. They do not see a bright economic future for themselves. More importantly, in many cases they do not see good prospects for their children, even if their kids sacrifice, work hard, and go to college. I am hearing that from more and more people in Michigan and across the country.

My great hope would be that we could take this strategy, which has now been laid out; and make it work. It is sensible. It fits together. It sees business, Government, and labor as joint partners in a Team America approach.

And, if we continue to press as hard as we can in terms of our national performance, I think we can rev ourselves up to a level of effort and achievement that will get the job done.

The rest of the world, for the most part, will not help us very much, quite frankly. The Japanese have their own agenda. The bureaucrats in Japan are among the most skillful anywhere in terms of double-talk and not finding practical answers to problems.

I look at the trade deficit numbers on automobiles and auto parts just for the month of July and it is just a staggering figure with Japan despite, as I said earlier, the change in the value of the dollar which should be closing that deficit up.

We have huge problems here. I hope that with the emphasis on Haiti and the emphasis on other problems that vie for our attention as a Nation, our resources, the President's attention, and the Cabinet's attention, that we will not take our eye off this problem for 1 minute.

This is the future of America. If we do not have this job base strong and growing, and real incomes rising that can support a family and hold families together, we are going to have more of the kind of unraveling of our society that we have seen in a lot of our urban centers; more of the kind of Clockwork Orange manifestations as I have described it many times before, where people do not feel like there is a role for them in the economic system because it is just too hard to break in and get enough of a toehold to come on up that ladder.

You and I were very fortunate coming along when we did in our lifetime so that we got the toeholds we needed and we came on up that ladder, Senator Moseley-Braun, Senator Boxer, Al D'Amato, and a lot of others here, but it has changed.

The only way we are going to have a bright future is to take this strategy and build on it.

So, I took all that time to say that as a predicate to a couple of questions, because if the press that is here does not understand this, and help the American people understand the importance of

the articulation and development of a workable strategy, then we will not have a strategy.

There are a lot of people who say we do not need a strategy. We should just sort of let things happen the way they happen and everything will work out just fine. Well, I think that in today's world that is a recipe for disaster.

We have to have a strategy, and you have helped lay one down. If you were to leave your job tomorrow—and I hope that will not happen—this will be one of the most important contributions that you will have made to this country. That is, to enable the focusing of effort and attention on a strategy that really gets down into the elements of what has to be done to allow us to succeed as a Nation and really give economic opportunity to our people.

I have four or five questions I want to ask, but I am going to yield to Senator Moseley-Braun, and then I will come back to my questions.

Secretary BROWN. May I just make a brief response to your comments, Mr. Chairman?

The CHAIRMAN. Please.

Secretary BROWN. First, I very much appreciate the complimentary remarks you made concerning my leadership at the Commerce Department. But most importantly, the way you formulated the issue. There is no question that we have to redefine a whole set of relationships in America.

One of those relationships that is in desperate need of redefinition that we think are achieving some success in redefining is the relationship between the public and private sectors; between Government, business, and labor.

If we are going to compete effectively in what is now a globalized economy, it takes new, creative, and dynamic thinking. It takes our ability to look beyond the horizon, so to speak. And that is exactly what we have been attempting to do.

I could not agree with you more about the importance of that kind of focus—the focus on global competitiveness. We are very proud of this report. I would certainly agree with you that we still have some steps to take, but we have I think a strong foundation on which to build.

We have taken a number of those steps in the last 18 or 20 months. I think they are steps in the right direction. The fact is that we have a plan. We have a strategy. We are implementing it, and it is working. I think we are seeing the results of that in our economy. We are seeing the results of that in the fact that the economy is not only growing, but we are creating jobs in the private sector.

I share your concern that we focus on assuring that those jobs are high-quality, high-wage jobs so that we can improve the standard of living of the American people. We certainly share the goals that you just expressed in your comments, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Moseley-Braun.

OPENING STATEMENT OF SENATOR CAROL MOSELEY-BRAUN

Senator MOSELEY-BRAUN. Thank you very much, Mr. Chairman. I am delighted to have an opportunity to review this report and I want to compliment the Secretary on the report, as well.

It is important to get, as we say at home, the true facts out about what is going on with this economy and our competitive position worldwide. Particularly in light of the fact that there is so much negativity being cast about, and people's hopes dimmed and frustrations exacerbated by a lot of the negative information.

I think it is of real importance to have this kind of substantive report published so that the public and the media and all of us in the Congress can have an opportunity to actually get a real good look at what has been going on with this Department.

I think there is a lot of good economic news to point to, and news that demonstrates the United States is in good shape vis-à-vis international competition.

Economic growth is healthy at 3.1 percent; and more than 4.1 million new jobs have been created since January 1993. Manufacturing productivity growth is strong. Corporate profits were up by 20 percent in 1993. And, inflation is low.

Moreover, in sector after sector of our economy, U.S. businesses that had lost ground to international competition are regaining their position. The strength of our domestic automobile industry is increasing steadily, and our high-tech industries are second to none.

However, as the report clearly demonstrates, there is still more to be done. There are major issues that need and deserve our attention. Our national savings rate is still much too low. We are not investing as much as our international competitors are. Our trade deficits are still too high. Growth in real income for average Americans has not kept pace. Since 1973, hourly compensation has increased at a dismal 4/10ths of 1 percent per year. So those are the kinds of challenges that you point to, Mr. Secretary, in your report and that the Chairman spoke of.

International competitiveness is not just numbers, however. It is about the lives of real people.

One thing is very clear, that if we were to meet and beat our international competition we have to make the right investments in education and training of our workforce. Again, I think that is the point, Mr. Chairman, that you were making when I came in: That these are really people issues and cannot be talked about just in balance-sheet terms; that they really do go to the heart of the quality of life for every American.

Those quality of life issues span a gamut of concerns from education and training, to job creation, to the kinds of jobs that get created, the high-wage/high-productivity jobs that you mentioned that allow people to maintain a family.

We are a rich country. We have the capacity to do it, and I am convinced that this Secretary has worked very diligently to bring what light he can on these many complex issues.

His Administration certainly has been an activist Administration. I cannot imagine picking up a newspaper and not hearing that Ron Brown is in some part of the world talking to people and trying to get them to Buy American. It is a pragmatic Administra-

tion, and it is a result-oriented Administration. I think, again, this report reflects all of that.

I am going to defer to the Chairman in terms of questions. We have multiple hearings around here, and so I have another set of hearings to get to. But I do have some concerns and questions to follow up with the Secretary in terms of particularly development of new markets and where we are going in that regard.

The point that you made in your testimony regarding the development of new technologies and new opportunities, I would very much like to hear the Secretary's response in terms of meeting the challenge of these trade deficits with new market development and new product development in those markets.

So I would defer to the Chairman before asking the question, but that would be the area in which I would like some response from the Secretary.

Secretary BROWN. May I comment, Mr. Chairman?

The CHAIRMAN. Please do.

Secretary BROWN. I could not agree more with what you have articulated, Senator Moseley-Braun. The fact is that this is really about how we have a positive impact on the real lives of real people.

This is not about ideology. It is not about philosophy. It is about how we can take a relentlessly pragmatic approach to improving the standard of living of the American people, to creating an environment for sustained economic growth, and to creating an environment for high-wage/high-quality jobs for our people. It is really very basic and very simple. It takes a coordinated effort to reach those goals, but we are absolutely determined to reach them.

We have problems to overcome. There is no question about that. But we are looking for new ways to approach what are really incredible opportunities in this new global marketplace where we are more and more interdependent, where, for example, it is a good thing for America to have a growing and prospering Mexican economy. Because it happens that the Mexican people like American goods, products, and services. So as that economy grows and the economies of our other trading partners grow, there are more resources to buy American goods, products, and services which translates directly to American jobs.

The fact is that American exports equal American jobs. Every billion dollar increase in exports means somewhere between 17,000 and 20,000 new jobs for the American people. We think that that is an important course to pursue, and we are pursuing it with great energy and great vigor.

Senator MOSELEY-BRAUN. Thank you, Mr. Secretary.

Thank you, Mr. Chairman.

The CHAIRMAN. Let me work off not just your current position but draw a little bit on your past experience. You spent about 13 years in important leadership roles in the National Urban League, struggling with the issues that confront our urban areas with a great professional commitment.

When you look at real wages for our less-skilled workers over the last 15 to 20 years, they have been declining in absolute terms. This grinding down of living standards in that part of the society has left us now with a growing number of families with fully em-

ployed adults who are not earning enough to get them above the poverty line. I would ask you to reflect on what is driving this trend that we are seeing. Obviously, what is it in this strategy that is most aimed at dealing with it? But what is causing this, as you see it, and what are we doing to change it?

Secretary BROWN. Well, let me respond first to the last comment, and that is: What are we doing to change it?

It seems to me that one of the most important things that the Administration did in its first budget submission was the Earned Income Tax Credit.

The CHAIRMAN. Exactly.

Secretary BROWN. That has not gotten the attention or the credit that it should.

What that single action does is assure that anyone who is out there working full-time is above the poverty line. It is a tremendous change. It is a Sea Change in policy in this country to address the very problem you are articulating, Senator Riegle. But much more needs to be done.

We need to assure, as our economy recovers and it clearly is recovering, that we understand that there is an old adage that does not always apply, and that adage being that a rising tide lifts all boats.

We know there are a lot of people in the communities in America who do not have any boats. There are a lot of boats that have gaping holes in them that are in need of repair. There are a lot of boats that are mired in the silt, the sludge, and in the sand at the bottom of the sea that we need to dislodge from that situation.

In order to do that, we are going to have to be focused in our approach to make sure that as economic recovery comes that everybody in America participates in that.

We have developed within our Economic Development Administration, for example, something we call the Competitive Communities Program, which I mentioned just briefly in my oral testimony. The concept there is to figure out how you can provide incentive for the relocation of job-creating industry in distressed urban and rural communities.

We think we have to go at that in a very focused way. We must press community level political officials, public sector leaders, nonprofit sector leaders, and educational institutions to come together and come up with a specific plan for the economic revitalization of that community.

It would not be just: I have identified Sector X as a hot sector of the economy, and therefore we want to try to attract some company from Sector X into our community. But it would be to go out and identify that company—Company Y. We would like to get Company Y in our community, and Company Y can produce 200 new jobs in our community.

Then the Economic Development Administration works with that community to come up with a package that provides the incentives that cause that company to make the decision to locate in this distressed community.

We think that is a very appropriately targeted way to try to approach this problem so that we don't just enlarge the affluent ring that surrounds the urban areas. The ring should be large enough

and/or wide enough to reach our distressed rural communities, so that as we have economic expansion, we insure it is dispersed all over the country rather than being concentrated in just parts of it. So we are taking what I hope you will agree is a creative approach to dealing with these issues.

We also, Mr. Chairman, I might say, have taken giant steps in the area of technology in this Administration. While we have been cutting the budget, there has been expansion in areas that affect technology and our ability to compete as far as civilian commercial technology is concerned. Through our Advanced Technology Program, which operates out of our National Institute of Standards and Technology, through the TRP program, through our Manufacturing Technology Center Program.

What this does, Mr. Chairman, is try to keep us on the cutting edge of technology; to cause us all to embrace technology as a friend, as a key to our economic future, as a key to job creation.

I know there is great apprehension about technology. Some people think of it as, well, if you have new technology it means you are more productive and you need fewer workers. In some senses that is the case. But I think we need to look at some important examples.

I can remember not too long ago where there was a tremendous and heated debate in America between those who cared about the environment and those who cared about job creation and economic growth.

We now find that just a few years later we have created a whole new sector of our economy called "environmental technology." We are number one in the world in environmental technology. There might be a day in the future where environmental technology is one of America's biggest exports—maybe its biggest export—therefore, creating hundreds of thousands of jobs in America. So we have to do that kind of creative thinking.

As far as manufacturing is concerned, Mr. Chairman, I am sure you have noted that for the first time in I think almost 20 years we have stemmed the loss of manufacturing jobs. That has leveled off. It is true that we are losing about 10 percent of our manufacturing jobs every year, but we are also gaining 10 percent new manufacturing jobs every year. So there is some churning going on.

We hope to begin to rebuild our manufacturing base, our industrial base. You can't be a first-class economy in the 21st Century if you allow your industrial base to continue to erode. Therefore, we are really pushing this concept of manufacturing extension, manufacturing technology centers, to put new technology in the hands of small- and medium-sized businesses so that they can grow and employ more people, so that they can be more productive and more competitive, and so that they can get into the export marketplace.

We are very proud of the strides that we are making. We are taking the number of manufacturing technology centers in America from 7 in 1992 to over 100 by 1997—again, focusing on small- and medium-sized businesses, which is where the real growth opportunity is.

The CHAIRMAN. You know, it is interesting. You mentioned the Earned Income Tax Credit. I again want to underscore that, partly for the benefit of the news reporters who are here. I think in that

huge budget bill, because so much of the focus was on the degree to which we were achieving deficit reduction, that the economic strategy components of that budget package were kind of pushed a little bit to the side. The Earned Income Tax Credit being one of those which is critical to dealing with some of these fundamental equity and income problems in the country.

Another aspect of that bill that relates to what you just said is the Empowerment Zone and Enterprise Zone Package.

As we come down the homestretch right now across the country with these applications, I will just say to you in the case of Detroit that you have a new Mayor, Dennis Archer, who has mobilized that community and we now have in the Empowerment Zone Package that has been developed all of the specifics. I mean, it is not buzz words and concepts. It is specific projects that will happen if that designation comes to Detroit.

So those partnership plans of business, Government, and labor now exists as a result of the competition for that limited number of Empowerment Zone and Enterprise Zone awards that will be made later this year. These partnerships show what can be done when business and Government work together to rebuild our inner cities.

Related to that, on Friday the President is going to sign our Community Development Bank Bill, which will get these Community Development Banks, modeled after the South Shore Bank in Chicago, started in inner city locations. I am proud that bill carries my name. But in addition to getting Community Development Banks going, to get that capital in where it has not been before, we also have a package in there of small business loan securitization.

This is an effort that Senator D'Amato has pushed very hard. It enables the packaging of small business loans, particularly from inner city borrowers and smaller businesses, to now be made and in turn packaged and sold into the secondary markets so that we can start to get a flow of capital coming in on the private sector side. This is similar to what we have done with the secondary market in home mortgages, which is to unlock huge pools of capital for home mortgages to reduce the cost of home mortgages so more people can become homeowners.

We now are on the edge of a flow of capital coming into that capital-starved part of our potential free enterprise business community that has been unable to get capital in the past.

There is a much bigger strategy at work here, the component parts of which are now in place. When the President signs that bill on Friday, as he will, we will roll that into play as part of this much larger strategy.

On page 73 of the report you discuss our trading relationship with Japan. A chart in the report shows that over $500 billion of our trade deficit since just 1980, a half a trillion dollars, is with Japan. I mean, that is all money that in effect has left the United States and gone to the Japanese. That includes $60 billion just last year alone.

Now, I know the Administration is working very hard to turn that around in the United States/Japan framework discussion, but what would you say to the charges being made by the Japanese

that the United States is "trying to manage trade" with Japan in these framework negotiations?

Secretary BROWN. I would say it is a little disingenuous of the Japanese to accuse anybody of managing trade. The fact is, we are doing just the opposite. We are trying to break down barriers. We are trying to open markets.

What we are doing is anything other than "managing trade." What we are doing is to try to get us to an era of global free trade. What we are trying to do is to get us to a period where Japanese markets are, in fact, open to American goods, products, and services. I do not think it is a legitimate charge, Mr. Chairman.

The Chairman. I must tell you, not to harangue the issue—and I have done that a lot—but the size of the bilateral trade deficit with Japan is just staggering. The fact is that it now exceeds a half a trillion dollars just since 1980 and that no matter how much the change in currency valuation seems to take place—which is one way that these problems are supposed to be corrected—we continue to see these massive structural deficits.

Over half the problem, as you know, is in one tier of activity—auto and auto parts. I do not see any way in the world that we are going to be able to have the kind of broad-based manufacturing strength in this country if we cannot get a fair shake in that area.

I do not just argue for the auto industry because it is a key home State industry for me, as it clearly is, but when you look at all the other industries in America, basic industries that feed into the auto industry—steel, aluminum, electronics, rubber—it is incredible the degree to which our entire industrial base is so connected to our transportation system and the production of cars and trucks.

So that grid of underlying strength, which you obviously see in wartime, as we did in the mobilization during World War II, but day in and day out in terms of the shear business sense and the flow of dollars and income to people, and companies, and States, and so forth, and the Federal Government, it is a gigantic economic engine in our country, and one that we have to have.

We do not have anything to replace it with if we were to squander it or give it away, or let somebody else raid it and have it for themselves.

I think in the case of Japan, especially because they have had this instability in their political leadership which gives the bureaucrats more power given the uncertainty at the political level, they have a million reasons why they cannot solve this problem.

I have to tell you, when I go home to Flint, or Pontiac, or Saginaw, or Detroit, or Muskegon, and the people out there who have job skills and want to work and cannot find work are scared to death their kids are not going to have decent opportunities, they have had it with that double-talk.

I do not know how we change it. We are awfully tough with the Haitians right now, as deservedly we should be, but we have a much bigger problem with Japan just in terms of the impact on this country.

This is a strategic problem of enormous size. We cannot afford to squander another $60 billion this year or next year in shipping it off to Japan who does not need it and clearly can buy an additional $60 billion worth of American goods.

Let us have an even trading relationship. You sell a lot here. You buy a lot of what we sell. It doesn't have to be dollar for dollar, but it can't be $60 billion out of whack in a given year. It can't be something on the order of $5 billion in 30 days leaving the United States and going to Japan? I mean, that will not work!

I hope that the President's blood pressure will go up on that issue, and that we will get the kind of hard-nosed efforts with respect to the Japanese that will put an end to the kind of predatory trading practices that exist here. Some of it is just the market being closed to our goods. Part of it is manipulation in other forums, but we have to get a handle on this.

I will just finish with this observation. I mentioned this problem of what happens when the middle class shrinks and you have a growing under class. This is an issue that I think about as much as any other, and I care deeply about it as I know you do. Your whole life history is a statement to that effect.

We had a situation the other day in Detroit where a mother of three went to a bank teller machine to get a few dollars to go buy some groceries. She was accosted by three youths and she was shot and killed by a 9-year-old who was accompanied by an 11-year-old and a 13-year-old. They apprehended these children later.

In talking with them, the children evidenced no real understanding of the magnitude of what they had done and the consequences for her widowed children and so forth. That is not an isolated event.

We are seeing too much of that too many places. In a sense, if we are going to have a growing under class in America where strategies either do not work or they take too long to work, we are going to have this kind of explosive circumstance that I do not think we can tolerate. It is wrong. It is inhumane. It violates everything we say we stand for as a Nation in our founding documents, and we do not have to settle for it.

We are not that impoverished intellectually or in terms of our resource base. It does not mean it is easy to solve the problems, but they can be solved. You have to have a commitment to solve them, as clearly you do, and I salute that and applaud that.

We have to take this strategy and we have to make it work. Everybody in the country is going to have to get on the team. I mean, "Team America" does not mean some of the public and not all of the public.

We have to get the business leadership, the labor leadership, the citizen groups, ministers, other community-based groups, elected officials at all levels of Government, citizens who care about the future of the country, to zero in on the question of how we make sure people in this country can earn a decent standard of living and sustain themselves. So that they will know that the country, in an over-arching sense, cares about them, wants them to be part of the economic system, and is operating our Nation in a fashion which makes it possible for everybody to participate in a meaningful way, and to get a real piece of the American Dream.

The American Dream is what it is all about. That is what we have been driving at. That is why we have had over 40 hearings here. That is why we have had over 100 witnesses sit at this table with the hope that eventually, if we pushed hard enough, we could

get a strategy going and get a President elected who cared enough about these issues to appoint somebody like you who cared about these issues, and those of us in the Congress in both parties who understand the urgency of it, that we could actually change the direction of the country.

That is what is involved here. That is why this hearing today is so important. I urge people to read this document—not just the areas where we are making progress, but the areas where we are still lagging behind. Those areas have to be cracked open and solved. We cannot wait much longer because time is running against us in terms of a failure to get those things turned around.

It is my great hope Senator Sarbanes will follow me as Chairman and I know—he wanted to be here this morning and couldn't be—that he cares deeply about these issues, as well, and shares a commitment to them similar to my own. So if he turns out to be the next Chairman of this Committee, I know this work will continue in this fashion.

I appreciate your commitment today and in the future, as well.

Secretary BROWN. Thank you, very, very much, Mr. Chairman for your graciousness. I have known you for over 20 years and have respected and admired your work greatly.

This Committee, this U.S. Senate, this Congress, this country will sorely miss your presence in this body.

You have demonstrated over the years a sense of purpose and mission, of compassion, of commitment, of caring about people, and I think that was clearly demonstrated in this hearing, as it has been in all of your work in the Senate.

I just want to tell you how much I personally appreciate, and the Clinton Administration appreciates, and I hope the people of Michigan and the people of America appreciate, the extraordinary contribution that you have made to our country.

The CHAIRMAN. Thank you. I appreciate that.

The Committee stands in recess.

[Whereupon, at 11:40 a.m., the Committee was recessed, to reconvene subject to the call of the Chair.]

[Prepared statements, response to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF SENATOR ALFONSE M. D'AMATO

Mr. Chairman, I would like to join you in welcoming Secretary of Commerce Brown today to discuss the Third Competitiveness Policy Report.

Today, the Competitiveness Policy Council is releasing its Third Repert to the President and Congress entitled, "Competing To Win In A Global Economy." The report focuses on successfully competing in a Global Economy through improvements in five areas: Civilian Technology, Trade, Economic Development, Sustainable Development, and Tracking U.S. Economic Performance.

The report covers many important issues to improve our country's competitiveness, but I would like to focus on two major points. First, the exporting potential of small businesses must be realized; and second, taking advantage of the dramatic growth in the Big Emerging Markets (BEM) to strengthen our trade position. These two areas need to be addressed while demanding open markets and protecting against unfair trading practices against U.S. companies. These efforts will help increase the ability of American businesses to compete on a global scale while creating more jobs for American workers.

Export finance for small businesses will improve a large untapped export asset. In June, I wrote to you asking for your support of a Export Assistance Center (EAC). In July, the Department of Commerce designated New York as a Regional EAC and also Albany, Westchester Co., Long Island and Harlem as District EAC's. I want to thank you for your assistance and support in designating New York as a location. New York, as the world's tenth largest economy in Gross Domestic Output, will fully utilize the EAC to continue our growth as a major player in the global marketplace especially in the small business sector.

In early 1994, the Trade Promotion Coordinating Committee (TPCC) set up U.S. Export Assistance Centers in Baltimore, Chicago, Miami, and Long Beach (California) with eleven more sites set to open in 1995. These one-stop shops who combine the export services of several Federal agencies are needed to provide the small businesses with a single point of contact with Government trade programs. Local governments should be encouraged to assist these small export businesses because they are best able to evaluate a local company's needs. The continuation and expansion of this program is essential in the promotion of small business exports.

The small- and medium-sized companies that make only a couple exports a year need to be encouraged to increase their output. In 1993, 50,000 companies made less than twelve overseas exports. The larger companies, which constitute a small minority of export businesses, accounted for the majority of our exports. Promoting this area will help increase our overall trade exports. To only focus on larger companies would ignore the potential of the small- and medium-sized companies.

In the area of trade with the Big Emerging Markets, the potential is unlimited. The (BEM's) share of World Exports, as stated in the report (p. 34), will likely double by the year 2010 and account for nearly 60 percent of all growth in world trade in that time period. We need to dramatically improve our exports in this area. Our exports to the new industrialized countries (Singapore, Hong Kong, Taiwan, and South Korea) saw a dramatic turn for the worse during the month of May 1994 over May 1993 when our trade deficit increased from $.51 billion to $1.12 billion (*Wall Street Journal*, July 20, 1994, pp. A1–A2). The opportunities for exporting to these countries are greater than the opportunities for trade to either the European Union or Japan and we are not taking advantage of them.

There have been some positive steps taken toward increasing our trade position, but we still have a great deal to do. The trade deficit for the first 5 months of 1994 increased to $41.96 billion from $25.84 billion over that time period in 1993 (*Wall Street Journal*, July 20, 1994) and since 1991 the trade deficit has continued to grow. These statistics make the point that more needs to be accomplished. Though the report covers many important issues, I believe in the importance of increasing the level of small business exports and increasing our focus on the Big Emerging Markets. These two focuses are vital to strengthening our economic position and creating U.S. jobs.

I look forward to the comments and suggestions of Secretary Brown today in regard to these and other issues.

PREPARED STATEMENT OF SENATOR CHRISTOPHER J. DODD

Thank you Mr. Chairman. I want to commend you for your leadership on the critical subject of today's hearing and welcome Secretary Brown. Few issues are more important to our Nation's economic preparedness than international trade. You have wisely devoted a significant amount of time and attention to ensuring that our Na-

tion's basic industries are prepared adequately with the tools they need to compete and succeed in the world economy.

I believe firmly that our Nation's future economic success is contingent on our ability to expand international trade opportunities and prepare our industries and our workforce for the increasing challenges of global economic competition. As the Congress prepares to consider the Uruguay Round Accord of the General Agreement on Tariffs and Trade (GATT), I think it is uniquely appropriate that we meet today to examine the success of our efforts to encourage research and development in vital industries, and renew our commitment to assisting our businesses in the new international economic marketplace.

The Need for GATT

Mr. Chairman, I would be remiss in my duties if I did not use this opportunity to put in a plug for GATT. I believe that the final Uruguay Round Agreement will significantly reduce tariffs and expand access to foreign markets. In the process, it will strengthen our economy and create hundreds of thousands of new American jobs. The Uruguay Round negotiations, which have spanned 7 years and three Administrations, will also achieve our principle trade objectives of broadening GATT's coverage to nontariff barriers, expanding GATT discipline to new areas of commercial activity, and increasing enforcement authority for trade violations.

Since the first multilateral trade negotiations began a half-century ago, GATT membership has increased from 23 nations to 115, and average tariffs have been slashed from 40 percent to 5 percent. During that time, the global economy has grown faster than during any comparable period of world history, and U.S. job creation in trade-related fields has grown at a rate several times faster than over-all job creation.

In my State of Connecticut, businesses have successfully capitalized on increased trade opportunities. Exports have been one of the few profit-making, and job creating industries during our State's recent economic difficulties. The State's exports grew by $5.5 billion from 1987 to 1993. And, the Uruguay Round Accord promises greater success for Connecticut industries as it strengthens intellectual property protection and increases market access.

Western Hemisphere Free Trade Agreement

In addition to our world trade efforts, I believe that we must expand trade opportunities in our own hemisphere. I have introduced legislation to give the President the authority to negotiate a comprehensive and inclusive Western Hemisphere Free Trade Agreement by the end of this century. The agreement would replace the current patchwork of bilateral and multilateral trade zones that now cover much of our hemisphere. All nations of our hemisphere would be welcome to participate in hammering out an agreement, and joining as members.

A Western Hemisphere Free Trade Area would comprise the largest single market in the world. It would include nearly three-quarters of a billion people and have a gross domestic product of more than $7.3 trillion.

Latin America and the Caribbean are becoming rapidly larger players in the global markets providing promising new markets for American exported goods. The region is now the United States third largest trading partner, surpassed only by Canada and Western Europe.

A Hemisphere-wide Free Trade Agreement would help cement the recent democratic and economic reforms in Latin America and encourage more of the same. Expanded trade is the best tool we have to strengthen the democracies of the region and prevent civil strife. And it is the best tool we have to expand markets thirsty for U.S. products.

In addition to expanding market access, our participation in a Hemisphere-wide Accord would strengthen our hand in trade negotiations with the Europeans and the Japanese. It would give us more leverage in opening up markets around the world. And, it would position our economy for success in the coming century.

Taking Advantage of Trade Opportunities

Expanding trade is a critical element of our national efforts to increase jobs and economic opportunities for Americans, but it is not the only element. In a new era of global economic competition, it is vitally important that we invest in the education and training of our workforce and bolster our Nation's industrial capabilities to ensure that we can compete successfully.

This is one of our most difficult challenges. But, throughout our history, we have been at our best when we have risen to face difficult challenges.

Thank you again, Mr. Chairman.

PREPARED STATEMENT OF RONALD H. BROWN

Secretary, U.S. Department of Commerce

"Competing To Win In A Global Economy"

September 21, 1994

Mr. Chairman and distinguished Members of the Senate Banking, Housing, and Urban Affairs Committee. It is my pleasure to appear before you this morning to present to the Congress my Second Annual Report on the International Competitiveness of the United States.

I particularly want to thank Chairman Riegle, Senator Sarbanes, as well as other Members of this Committee, for having focused the country's attention on the challenges of competitiveness. For many years this Committee has held hearings on this critical subject, and I would like to commend you for your foresight and perseverance.

Last year, I was able to tell you primarily of challenges faced and initiatives planned. This year I am pleased to report a record of solid accomplishment as well as progress made toward pursuing our opportunities in the global market and tackling some of our fundamental economic problems.

Against the backdrop of rapid changes at home and abroad, Americans have rightly been concerned about our country's standing in the world economy. In the late 1980's and early 1990's, many studies sounded alarms about declining competitiveness. More recently, a good deal of this pessimism has been reversed as the United States regained much lost ground and laid the foundation for even more progress in the future.

The bottom line of this report is simply this: Our economy is back on track, our prospects in the global marketplace are very bright, but that there are, nevertheless, some daunting challenges ahead. Those challenges are not, in the narrowest sense, merely issues of economic policy. This Administration views "competitiveness" in the broadest possible terms, encompassing not just trade policy, but technology, savings and investment, education and training, the health and safety of our citizens, and the cohesion of our communities. In our view, enhancing competitiveness should be a consideration in all of our policies, because the global economy now affects almost every aspect of our way of life.

A summary of our immediate economic position is, as Vice President Gore has recently said, "What should be up is up, and what should be down is down." Fundamentally, what "should be up" is private sector job creation and economic growth. The basic objective of all our policies is to improve the U.S. standard of living—something that can be accomplished only if Americans have good jobs. When President Clinton took office he pledged to create 8 million jobs in 4 years. Under his leadership over 4 million jobs have been created in 1½ years—1.7 million more than were created in the 4 years before he took office. Indeed, our rate of job creation is more than four times the pace per month than for the previous 4 years.

The U.S. economy, as measured by the real gross domestic product, grew 3.1 percent in 1993, and at an annual rate of 3.3 percent in the first quarter and 3.8 percent in the second. Since January 1993, this growth rate has been more than three times the average growth in the period 1990–92.

What "should be down" is unemployment and inflation—and they are. The unemployment rate has fallen from 7.7 percent in June 1992 to near 6 percent at the present time. Despite the strong recovery, consumer prices of goods and services have increased only 2.6 percent over the past year and producer prices are up only slightly.

This good news is no accident. It has been driven by the Administration's success in reducing the Federal budget deficit and by new Clinton Administration initiatives, including those we have begun at the Department of Commerce in the fields of technology, trade, economic development, and sustainable development. As the President has said, the adoption of his budgets "will give us 3 years of deficit reduction for the first time since Harry Truman was the President of the United States. . . . We have the basis for the first growth in America in 30 years that is led by investment and that has no inflation. . . ."

The Department of Commerce is deeply committed to helping U.S. companies become more competitive in the global economy. As we are proving every day, from the Pacific Rim to Latin America to the European Union, American workers are the most productive in the world, and American products, services, and technology are in increasing demand in every corner of the globe. We're not afraid to compete with anyone, at home or abroad. As President Clinton has stated, "Open and competitive commerce will enrich us as a Nation . . . it spurs us to innovate. It forces us to

compete. It connects us with new customers. It promotes global growth without which no rich nation can hope to grow more wealthy."

And our private sector welcomes the opportunity to compete. It is the private sector that drives the engine of economic growth. Our role is to work with industry, labor, and academia to create a healthy, sustainable foundation on which U.S. companies are able to compete and win in the global economy.

Even though our growth in productivity has shown recent strength, the U.S. economy has suffered a slow rate of productivity growth for the last 20 years—only 1 percent per year compared with nearly 3 percent from 1950 to 1973.

Productivity, or the output per hour worked, is the fundamental determinant of a nation's standard of living. In the long run, if a nation cannot improve productivity, then it cannot consume more either. It is also true that if a country does not become more productive, producing high-quality goods more efficiently, it will be disadvantaged in international trade. So productivity, the standard of living, and international competitiveness are inextricably intertwined.

The root causes of slow growth in productivity over the last 20 years seem plain.

- *National saving is low.* Net national saving averaged 1.8 percent of GDP since 1990, compared with 8.1 percent in the 1960's, 7.2 percent in the 1970's, and 3.7 percent in the 1980's.
- *Investment is also low.* Correspondingly, net fixed investment was under 3 percent of GDP for the 1990's compared with 6.5 percent for the 1960's and 1970's, and 5 percent in the 1980's.

Slow growth in saving and productivity has also led to slow growth in real labor compensation.

- *Labor compensation gains have been slow.* Labor compensation per hour, after adjusting for inflation, has increased only 0.4 percent per year since 1973 as compared with 3.0 percent per year for 1950 through 1973.
- *Family income growth is uneven.* The distribution of gains across income classes has been unfavorable. Those with higher incomes have gained while those at the lower end have lost considerable ground during the last 20 years.
- *A long-term trade imbalance remains.* Since 1976 the United States has continuously run trade deficits, although the recent deterioration in the deficit reflects primarily the stronger U.S. economy in comparison with Europe and Japan.

In some aspects, the United States compares very favorably with other industrial nations, the fellow members of the G–7, but in others we fall short.

- *The U.S. standard of living remains the highest.* The U.S. GDP per capita of \$24,545 compares favorably with the next highest, Japan (\$20,224) and Germany (\$17,306), when using exchange rates that take into account higher prices in these countries.
- *But growth has been slow.* Since 1950 U.S. GDP per capita has risen only 1.8 percent per year, while in Japan the rate has been 5.2 percent per year and in Germany 3.1 percent.
- *U.S. job growth is high.* Among the G–7 nations only Japan surpasses the United States in the rate of job growth over the past 5 years. The U.S. unemployment rate is also lowest, except for Japan.
- *The U.S. budget deficit is among the lowest as a share of GDP of the G–7 countries.* And Administration policies will reduce that even further.
- But, *net investment is very low compared with others.* Net investment in the United States, as a share of GDP, is only one-quarter that of Germany and one-eighth that of Japan.
- *Educational performance is a main concern.* U.S. 13-year-olds score lower on international math and science assessments than many of their European and Asian counterparts.
- *U.S. health care costs are by far the highest in the world.* Per capita health costs in the United States dwarf those in other countries. In 1991, U.S. expenditures per capita were nearly \$2,300, compared with Canada, \$1,500; France and Germany, \$1,300; Japan, \$1,000; and the United Kingdom, \$850.

WE MUST RECOGNIZE THAT NEW CHALLENGES ARE EMERGING

- *Big Emerging Markets represent a new competitive challenge.* The group of Big Emerging Markets among the developing countries—China, Taiwan, India, Indonesia, and South Korea in Asia; Mexico, Brazil, and Argentina in Latin America; and South Africa, Turkey, and Poland in Africa and Central Europe—is becoming increasingly important both as markets for U.S. exports and as competitors for U.S. producers.

- *Competitiveness requires adaptable workforces.* The shift is away from less educated workers toward those with developed problem-solving skills. More rapid economic and technical change requires increased investment in labor skills.
- *Civilian technology policy makes a direct contribution to competitiveness.* In a world in which product cycles are short and many technologies spread rapidly around the world, maintaining a technological edge will become even more important to a rising standard of living.
- *Information technologies are critical* to competitiveness in the 21st Century. Opportunity and challenge are presented by new industries.
- *Other "next generation" trade issues must be addressed.* Environment, labor standards, competition policies, and foreign technology policies all present significant challenges to U.S. competitiveness.

The report I am presenting to you today highlights initiatives that must be maintained and areas where additional efforts are needed if the United States is to improve the competitiveness and standard of living of its people. Among these are:

- Continued budget deficit reduction to expand the pool of savings and to increase investment.
- Passage of the Uruguay Round legislation.
- Expanded export promotion to boost U.S. exports and high-wage jobs, with a particularly intense focus on the Big Emerging Markets.
- Continued shifting of Federal R&D priorities toward a 50/50 split between civilian and defense technologies.
- Focused USG policies that promote and support further development of the National Information Infrastructure by the private sector, including passage by Congress of telecommunications reform legislation that will promote competition and expand the telecommunications marketplace.
- Enabling small- and medium-sized manufacturers to compete through a national network of manufacturing extension centers.
- Continued expansion and improvement of education and training programs.
- Improving productivity through health care reform, welfare reform, and crime reduction.
- And finally, addressing "next generation" trade issues regarding the environment, labor standards, competition policies, and technology policy.

Clearly we have much work to do to improve our competitiveness over the long haul. The Department of Commerce is a crucial part of this effort.

DEPARTMENT OF COMMERCE EFFORTS TO IMPROVE U.S. COMPETITIVENESS AND RAISE U.S. LIVING STANDARDS

Recently, a private sector study conducted by the International Institute for Management Development and the World Economic Forum rated the United States as the world's most competitive nation. That's good news—but there's much more to be done. The Commerce Department's policies and programs support the Administration's goals of strengthening America's performance in the international and domestic marketplace, raising living standards, and creating more and better jobs for the future.

The Commerce Department's strategy is to help create the environment and the tools to facilitate productive activity in the private sector—activity that expands opportunity for all Americans, that helps to enlarge the employment base, and that strengthens our communities. These goals are pursued through our programs to develop and diffuse technology, to build an information infrastructure for the 21st Century, to pursue market openings abroad and vigorously promote American exports, to protect our intellectual property rights and to enforce our trade laws, and to invest in our communities.

In the 1980's and 1990's, when concern about America's competitive standing arose repeatedly, much of the criticism of the Government's response was leveled at the lack of an overall framework which tied together trade, technology, and other issues. Policies were developed along separate tracks, thereby preventing the establishment of broad strategies to help American firms compete in the global market.

Today, it is one of the Department of Commerce's highest goals to recognize the linkages among its various programs and to develop broad policies that build on those relationships. Investments in new technologies, for example, will result in new possibilities for U.S. exports. Exports will create more and better jobs and thereby strengthen our communities. Investment in technology will help us build a National Information Infrastructure that will serve to improve our education system, create jobs, and expand our exports of goods and services—all leading to higher standards of living.

These five related areas—civilian technology, trade, economic development, sustainable development, and tracking U.S. economic performance—are the subjects of Part II of the Report.

First, Civilian Technology

Technical innovation and commercialization is an imperative of economic growth economy. Rapid and continuous improvements in products, and the techniques to manufacture and bring them to market more efficiently, are now what give businesses—and nations—a critical competitive edge. In this environment, the high-technology sector is critical to economic prosperity. Average annual compensation in the high-technology sector, for example, exceeds by 20 percent the average for all manufacturing.

High-technology products also account for a rapidly increasing share of the manufacturing output of industrial countries—35 percent in 1992, nearly double that of 1980. By any measure, maintaining our competitiveness in technology development, deployment, and use is essential to our Nation's economic future.

Almost immediately upon taking office, the Clinton Administration adopted a new technology policy to support the development and commercialization of civilian technology. The Administrative's policies and programs assign the Federal Government a supporting role, performing as a partner to industry by facilitating technology development and applications. This entails:

- Shifting Federal R&D resources toward a 50/50 balance between military and commercial spending.
- Launching of the Technology Reinvestment Project, and expanding the Advanced Technology Program.
- Enabling the creation of the National Information Infrastructure and the Global Information Infrastructure.
- Establishing a national network of manufacturing extension centers.
- Extending the R&D tax credit.

The Department of Commerce has established a four-part program to enhance the technological capabilities of American business and industry. These programs are based on the recognition of the primacy of civilian technology to economic growth, and on the role of industry as the primary creator of new technology and the main engine of sustained economic growth.

The Development of High Risk, Advanced Technologies

- The Commerce Department's Advanced Technology Program (ATP) has been dramatically increased. Designed to spur industry's development of high-risk, high-payoff commercial technologies, the ATP has been expanded from a pilot program in 1992 to a $431 million national program for FY 1995.
- The Department has continued to emphasize manufacturing by increasing funding of its Advanced Manufacturing Research Programs and other research efforts at the National Institute of Standards and Technology (NIST), and its support for environmental technologies at both NIST and the National Oceanic and Atmospheric Administration (NOAA).

FACILITATING THE DEPLOYMENT, DIFFUSION, COMMERCIALIZATION, AND USE OF TECHNOLOGIES. Department initiatives include:

- The NIST-managed Manufacturing Extension Partnership, which has established a nationwide network of manufacturing extension centers to assist small- and medium-sized business to modernize and become more competitive.
- The Department's Office of Air and Space Commercialization, which has promoted the trade of space-related goods and services, while numerous Cooperative Research and Development Agreements (CRADA's) and other cooperative partnerships with private and public sector organizations have promoted research, development, deployment, and use of technologies that increase the competitive position of U.S. companies in the global economy.

Working closely with industry the Department of Commerce has acted as a voice for our businesses and industry "customers" in Government-wide technology efforts, including the National Science and Technology Council. In addition, the Technology Administration has taken a number of steps to work more closely with industry:

- Facilitating the creation of public-private partnerships, including the Partnership for a New Generation of Vehicles.
- Promoting the development of industry "Road Maps," that help industry set technology goals, identify barriers to competition, and design appropriate Government and industry actions.

- Developing "Benchmarks" for assessing the relative strengths and weaknesses of several strategic industries and sectors of the economy.
- Assessing the technological strengths of our international competition and creating mechanisms for U.S. firms to access that technology. Specific programs include the United States-Japan Manufacturing Technology Fellowships for work in Japanese industry, the Intelligent Manufacturing Systems for international collaboration on manufacturing technology, new on-line data systems for international technology awareness, and Science and Technology agreements for precompetitive research collaboration in certain strategic countries in Europe, Asia, and the Middle East.

Creating a 21st Century information infrastructure. The Administration has launched an ambitious effort to stimulate the development and deployment of an advanced National Information Infrastructure (NII). This effort is guided by five principles: Encouraging private investment, promoting competition, creating a flexible regulatory framework, providing open access, and ensuring Universal Service. Under the leadership of Vice President Gore and through the interagency information Infrastructure Task Force which I chair, the Administration is working closely with business, labor, academia, and public interest groups as well as Congress, and State and local governments. The Department of Commerce has taken a number of steps to aid our efforts. These include:

- Establishing the private-sector National Information Infrastructure Advisory Council.
- Convening a Federal-State-Local planning conference to allow for discussion of communications and information policy issues, such as universal service.
- Holding hearings on universal service and open access, privacy and security, intellectual property rights, R&D, standards, and other issues.
- Releasing for public comment a number of draft reports and papers including "A Vision for Government Information Technology Services, and the NII," "Putting the Information Infrastructure to Work," and "The Information Infrastructure: Reaching Society's Goals."
- Promoting passage by Congress of telecommunications reform legislation that will promote competition and expand the telecommunications marketplace.
- Initiating an ambitious grants program, administered by the Department of Commerce's National Telecommunications and Information Administration, to provide $26 million this year and more than $60 million next year in matching funds to State and local governments, school districts, health care providers, and other nonprofit entities for NII pilot and demonstration projects.
- The development of Fed-World at NTIS has brought the Government's technology and business-related data bases to the wide audience of the Internet users at no cost to the Government.

Information is important to the global economy. The interagency task force has been hard at work facilitating the cooperative development and implementation of the Global Information Infrastructure (GII). The GII initiative will be accomplished through the cooperative efforts of countries working together—bilaterally, regionally, and through multilateral organizations. To develop a broader understanding of the policy issues associated with the development and implementation of the GII, we have held public hearings and are currently developing a new report entitled "GII: Agenda for Cooperation."

Second, Trade

A key component of enhanced competitiveness for U.S. firms and workers is the maintenance of an open trading system. The Department's efforts are directed to three strategies: Market opening initiatives, enforcement of trade laws, and export promotion.

Market Access Initiatives. Commerce has worked vigorously with other agencies of the Federal Government to achieve greater access for U.S. exporters.

- *Uruguay Round.* The Uruguay Round will create enormous potential for world trade and economic growth through tariff reductions, extension of GATT rules to intellectual property, services and trade-related investment measures, and improvements in trade rules. Securing passage of legislation implementing the round is critical to 21st Century competitiveness.
- *Regional Initiatives.* The Department is an important participant in numerous initiatives, including:

—*NAFTA implementation,* to ensure American business takes advantage of the opportunities created by this agreement;

—Negotiations and trade promotion efforts in *Japan,* to open this historically difficult market;
—Ongoing efforts in *Europe,* to ensure that expansion of the "single market" does not disadvantage the United States;
—Identification of key countries with maximum opportunities for the growth in U.S. exports—the *Big Emerging Markets,* particularly in Asia and Latin America—as a new focus for our commercial policy efforts; and
—Efforts to assist the *Economies in Transition*—from Russia and the Newly Independent States to the Middle East—to meet the challenges of democratization through enhanced participation in the global market economy.

TRADE LAW ENFORCEMENT. Unfair foreign pricing practices and government subsidies distort the free flow of goods, adversely affect U.S. business and reduce the ability of U.S. firms to compete in the global marketplace. The antidumping and countervailing duty laws, administered by the Commerce Department, provide remedies to these unfair trade practices. The Department is committed to the vigorous enforcement of the laws and implementation of the improvements negotiated in the Uruguay Round.

BUILDING A NATIONAL EXPORT STRATEGY. The Trade Promotion Coordinating Committee (TPCC), an interagency task force of 19 agencies that I chair, is an effective forum for dramatically improving Federal cooperation and launching new interagency trade promotion initiatives. The TPCC will issue shortly its second annual report to Congress detailing implementation status of the National Export Strategy. I look forward to presenting the TPCC Report to you in the near future. However, allow me to note here the following highlights of progress to date.

- *Advocacy.* We have established an interagency network with an Advocacy Center at the Department of Commerce as the central contact point and clearinghouse for information and action on major projects of benefit to American firms. Many successes have already been registered.
- *Export Finance.* The TPCC is implementing a more flexible and aggressive approach to trade finance, including: Creating a $150 million Capital Projects Tied Aid Fund, establishing a new outreach office at Commerce on multilateral development bank procurement opportunities, and raising the Overseas Private Investment Corporation's project limit to $200 million under each of its insurance and guaranty programs.
- *Export Controls.* Consistent with national security objectives, the Clinton Administration has liberalized controls on computers and telecommunications exports, has streamlined the export controls process, and is seeking new legislation to establish a regime of export controls for the post-Cold War world.
- *U.S. Export Assistance Centers.* Pilot interagency one-stop shops are now open in Baltimore, Chicago, Miami, and Long Beach.

CREATING A NATIONAL TOURISM STRATEGY. The U.S. Travel and Tourism Administration is also hard at work keeping the U.S. competitive in the growing tourism market. For the past 10 years, travel throughout the world has increased at an annual rate of 9.6 percent. *Each day* in 1992, 1.3 million people travelled to a country outside of their own, and spent an average of $764 million. In 1993, the United States generated some impressive numbers of its own—45 million visitors and over $74 billion in revenues. This phenomenal growth is sure to continue as more countries liberalize their economies and as travel restrictions are lowered in emerging markets. The United States is expected to reap its fair share of that tourism growth as people from these nations flock to America to see first hand the extraordinary country they have heard so much about. That increase can result in a sensational boost to America's travel and tourism industry.

In order to remain competitive in the global marketplace, the United States needs to develop a national tourism strategy. President Clinton and the Department of Commerce have taken the first step toward developing that strategy. On February 23, 1994, I announced President Clinton's decision to hold a White House Conference on Travel and Tourism, tentatively scheduled for November 1995. The White House Conference will focus attention on the tourism industry's crucial impact on the Nation's economy, the potential for tourism as a catalyst for economic growth, and the challenges facing this important sector of the U.S. economy as it moves into the 21st Century.

Third, Economic Development

An important responsibility of Commerce is to provide assistance to those communities and businesses bypassed by the process of economic change or that have suffered economic dislocation as a result of economic change. Such efforts strengthen

the Nation's competitiveness by helping all segments of our economy to grow and prosper. Key elements include:

Regional Development. I recently announced the Competitive Communities program, an aggressive plan by the Economic Development Administration (EDA) designed to support local efforts to build, support, and attract competitive businesses in urban and rural communities. EDA also provides support for local development through such activities as public works, technical assistance, trade adjustment assistance, and university centers.

Minority Business Development. In addition, through the provision of management and technical assistance, the Minority Business Development Agency seeks to bolster the competitiveness of minority businesses. With racial and ethnic minorities constituting over 26 percent of total U.S. population, the economic health of the Nation demands that we remove barriers that inhibit the minority business community from achieving its full potential. We are working on a legislative proposal to codify MBDA's authority and enhance its ability to assist this critical segment of the economy.

Fourth, Sustainable Development:
Economic Growth and Environmental Goals

The Clinton Administration is integrating economic development and environmental stewardship, in a balanced manner, for the present and future benefit of all Americans. This is the essence of the evolving concept of sustainable development—defined as development that meets the needs of the present without compromising the ability of future generations to meet their own needs.

With its responsibilities to promote economic growth, expand international trade, advance civilian technology, foster community development, protect natural resources, and monitor the environment, the Department has an important role in simultaneously stimulating economic growth and advancing environmental stewardship. Recognizing this, I am the first Commerce Secretary to place the mission of Commerce—to ensure and enhance economic opportunity for all Americans—within the context of sustainable development. In doing this, the Department works with other Federal agencies, including the Departments of Energy and the Interior and the Environmental Protection Agency, and with partners outside the Executive Branch, to advance the shared goals of sustainable development.

The Department promotes sustainable development in many ways:

- First, by creating the opportunities and incentives for businesses, communities, and individuals to prosper through environmentally sound growth. This includes:
  —Supporting and promoting the U.S. exports of environmental technologies to the rapidly growing world markets;
  —Participating in industry-government partnerships in key sectors—such as autos—to simultaneously reduce environmental impacts while increasing competitiveness; and
  —Integrating economic-environmental data for national accounts is an important step toward improved information for decision makers.
- Second, by improving environmental monitoring, prediction, and assessment. This involves:
  —Predicting changes and trends in weather and climate, and the risks they create; and
  —Developing the knowledge required for integrated ecosystem management—so that economic growth can proceed in a sustainable manner.
- Third, by encouraging the development and diffusion of eco-efficient technologies. Such technologies enable companies to use natural resources more efficiently and to minimize the costs associated with pollution, thereby improving their competitiveness and profitability. Commerce advances the development and use of eco-efficient technologies, through:
  —Laboratory-based research;
  —Support for industry research and development; and
  —Diffusion of environmentally sound state of the art technologies.

Fifth, Tracking U.S. Economic Performance

Both business and Government depend upon critical data to plan and implement efforts to become more competitive. Efforts are currently underway throughout the Economics and Statistics Administration (ESA) to improve the quality of reporting on U.S. economic conditions and international competitiveness issues. For instance, the Census Bureau is greatly expanding the collection of data pertaining to the rapidly growing services industry, especially data related to the communications, fi-

nance, and transportation industries and to exported services. The Bureau of Economic Analysis, moreover, is now engaged in modernizing its national economic accounts, with one aim being to make our accounts more comparable to the accounts of other industrialized countries.

Conclusion

With opportunities expanding all around us, we recognize the challenge of making certain that all of our citizens benefit from our progress in the world economy. We are bringing new, future-oriented business into the urban core. We are encouraging the expansion of business formation for minority entrepreneurs and other central city residents. We are helping business in the inner city expand into growth industries and to export products to other countries.

As this report makes clear, there is still much to do. We face great challenges in boosting our investment levels, in improving our secondary education systems, in training our workers, and in opening foreign markets. But America has been very much on the move in the world economy in the first 18 months of the Clinton Administration, and we should be proud of our achievements.

I look forward to continuing to work with you for a strong, highly competitive America.

Dear Mr. Chairman:

I appreciated the opportunity to testify at the Banking, Housing, and Urban Affairs Committee's September 21, 1994, hearing on U.S. Competitiveness and Trade Policy. Enclosed are the answers to the written questions.

Because all Commerce programs are designed to improve the living standards of all Americans, competitiveness is very important to me. As I said in my testimony, America has been very much on the move in the world economy, and we should be proud of our achievements. Our report, *Competing To Win In A Global Economy,* also makes it clear that there is still much to do. We face great challenges in boosting our investment levels, in improving our secondary education systems, in training our workers, and in opening foreign markets.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM RONALD H. BROWN

Q.1. The Commerce Department report states on page 28 that: "Labor costs in the U.S. have risen more slowly than those of our trading partners thus increasing our competitiveness." Falling relative wages for workers is one way to compete. A better way, in my view, is to give our workers better education and tools so that they can compete without relative falling wages. Do you agree with that and is not that one of the reasons we must increase investment in our economy?

A.1. Certainly, as the report says, we must do a better job of educating and investing in our workforce. However the reference in the report is to slowly rising *unit* labor costs. Unit labor costs measure the amount of wages paid per unit of output. If productivity improves, as it has since 1989, faster than the amount of wages paid to produce a unit of output, unit labor cost will decline even though real wages may be increasing. This does not mean that the United States is worse off. If unit labor costs rise quickly, it could be a sign that inflation is out of control or that productivity has not increased.

A good example is a comparison of the United States and Japan in 1992–93. U.S. hourly compensation increased 3.6 percent and our productivity increased 4.2 percent leaving us with unit labor costs declining .6 percent. Japan's compensation increased only 2.7 percent, and its productivity actually went down .6 percent, leaving Japan with unit labor costs increasing 3.3 percent. It is much better to be in the position of the United States, with both increasing productivity and compensation, than that of Japan, with declining productivity and slowly increasing compensation. In short, declining unit labor costs are usually viewed as a positive economic indicator.

Q.2. The Commerce Department report states on page 35 that: "One of the strengths of the American economy is its ability to create jobs. But many of those jobs are in low value added areas in which pay is relatively low." How can we create more higher paying jobs that permit workers to support their families and thus strengthen our communities?

A.2. The Department is focusing on the three areas of support for civilian technology, maintenance of an open trading system, and economic development to help create and sustain high paying jobs and strengthen communities.

Rapid and continuous improvements in products, and the techniques to manufacture and bring them to market more efficiently, are now what give businesses and nations the competitive edge. In this environment, the high technology sector is critical to economic prosperity. Average annual compensation in the high technology sector exceeds by 20 percent the average for all manufacturing. The Department of Commerce has established a four-part program to enhance the technological capabilities of American industry.

- The development of high-risk, advanced technologies through a dramatic increase in the Advanced Technology Program (ATP), that is designed to spur industry's development of high-risk, high-payoff commercial technologies.
- Facilitating the deployment, commercialization, and use of technologies through the establishment of a nationwide network of manufacturing extension centers. These manufacturing extension partnerships help small- and medium-sized businesses to modernize.
- Working closely with industry by facilitating the creation of public-private partnership, including the partnership for a new generation of vehicles.
- Creating a 21st Century information infrastructure by stimulating the development and deployment of an advanced national information infrastructure (NII).

The maintenance of an open trading system is a key component to enhanced competitiveness for U.S. firms and workers. Between 1986 and 1992, the number of jobs associated with exports rose from 6.7 million to over 10 million. Moreover, jobs supported by goods exports paid 13 percent more than the average wage.

The Department of Commerce has taken a number of initiatives to ensure that U.S. firms and workers can continue to compete effectively. First, we have focused on market-opening initiatives on a global, regional, and bilateral basis, ranging from the Uruguay Round negotiations to the framework talks with Japan. Second, we have enforced the Nation's trade laws to ensure free and fair trade in our domestic market as the basis for our market opening initiatives. Finally, we have undertaken unparalleled export promotion efforts aimed at providing American businesses with the information, finance, and other Government assistance that can enhance their competitiveness.

The third area is economic development to provide assistance to those communities and businesses bypassed by the progress of economic change. The Economic Development Administration has designed a plan to support local efforts to build, support, and attract competitive businesses in urban and rural communities. The Minority Business Development Agency assists in the development of minority businesses through management and technical assistance.

Q.3.A. Your report states that productivity grew only 1.0 percent annually from 1973 through 1993, compared to an average rate of 2.8 percent per year between 1950 and 1973. The report further

states that growth in productivity is an essential element in competitiveness and is a necessary element in improving our standard of living and worker compensation. What specific initiative should be implemented to increase our productivity?

A.3.A. Clearly, the activities of the private sector drive our competitive position, but Government plays a strong supporting role. Government's role is to work with industry, labor, and academia to create a healthy, sustainable foundation on which U.S. companies are able to compete in the global economy. The report highlights initiatives that must be sustained and areas where additional efforts are needed if the United States is to improve its productivity and the standard of living of its people. Among these are:

- Continued budget deficit reduction to expand the pool of saving and increase investment.
- Continued expansion and improvement of education and training programs.
- Expanded export promotion to boost U.S. exports and high-wage jobs, with a particularly intense focus on the big emerging markets.
- Continued shifting of Federal R&D priorities toward a 50/50 split between civilian and defense technologies.
- Focused policies and programs to support the creation of the NII.
- Enabling small- and medium-sized manufacturers to compete through a national network of manufacturing extension centers.
- Continued implementation of the National Performance Review.
- And finally, improved productivity through health care reform, welfare reform, and crime reduction.

Q.3.B. What specific technological areas should we be focusing on?

A.3.B. The process of identifying key technology areas is one which we have learned a lot about in the past few years. Initially, a number of different "critical technology" reports were issued by public and private groups, identifying the technologies of greatest future importance to U.S. competitiveness. The reports all contained similar lists of broad technology areas with little detailed attention to the potential applications of the technologies.

Both industry and Government have come to recognize that technologies themselves are only intermediate steps in the chain of activities that leads to the new products and processes determinative of competitive positions. New processes, generated by new technologies, can contribute to competitiveness by lowering the cost of production, and new technology products can create new and unique sectors in the international marketplace.

For that reason, it is important that the Government approach technology development in the context of specific industrial applications. At the same time, it is essential that the judgments about the commercial significance of such applications be made by industry and not by Government. The Government's job is then to encourage partnerships between itself and industry to address some of the basic technical challenges residing in the areas most important to industry. We have applied this kind of process to the development of the research agenda for the partnership for a new generation of vehicles and are also basing efforts to assess the prospects for a new electronics industry initiative on this approach.

Similarly, our efforts to create focus areas for the ATP are premised on the same process of looking to industry for advice on key areas for commercial application and on the fundamental challenges posed in attempting to develop those applications.

In the Department of Commerce, we are working with industry, academia, and other Federal agencies to generate a broader analytical approach which we believe will be helpful in identifying key technology challenges relating to the competitive position of strategic U.S. industries. An important part of this initial "competitiveness benchmarking" work will be the identification, of the role that certain critical technology areas play in the relative strength of each industry studied. This process will give industries a better means of understanding their own competitive situation and will also generate information useful to the Government in identifying key technology areas where it may play a role in researching generic and precompetitive issues.

Q.4. On September 7, 1994, the *Wall Street Journal* carried an article entitled "Global Report Finds U.S. Has Replaced Japan as the Most Competitive Economy." This and other articles have led some to claim U.S. competitiveness is not a problem anymore. Do you agree? If not, why?

A.4. The *World Competitiveness Report* focuses on the short term, while our report looks more at the structural elements of competitiveness. Also, our report does not attempt to come up with a final ranking of the competitiveness of various countries. While the U.S. ranking in the *World Competitiveness Report* helps confirm my sense that our economy is doing relatively well, there are a number of formidable challenges that are discussed in the Department's report.

- Long-term trends in productivity and labor compensation are sluggish. From 1973 through 1993, productivity growth was less than half of the 2.8 percent rate from 1950 to 1973. In addition, U.S. productivity growth since 1985 has only been slightly above the average for the G–7 nations. Sluggish growth in productivity has led to a rise of only 0.4 per year in compensation per hour since 1973 compared with 3.0 percent a year from 1950 through 1973.
- Savings and investment problems remain. Net national savings has averaged only 1.7 percent of GDP since 1990, compared with over 7 and 3.5 percent in the 1970's and 1980's. Correspondingly, net fixed investment has averaged under 3 percent of GDP since 1990, compared with 6.5 and 5 percent in the 1970's and 1980's. In addition, U.S. net fixed investment as a share of GDP is slightly more than half that of Germany's and only one-fifth that of Japan's.
- Family income growth is uneven. Families with higher incomes have gained while those at the lower end have lost considerable ground during the last 20 years.

Q.5. Your report notes on page 31 that, although the gap between the standard of living of Americans and our major competitors has closed steadily, Americans still enjoy a higher standard of living than citizens of the other major industrialized countries.

Many experts, however, believe if our present trade and savings patterns continue Americans will soon fall behind our main competitors in living standards and could in another quarter century fall way behind. Do you agree? If so, what can we do to prevent that?

A.5. As is stated throughout the report, our low savings rate is a formidable challenge. I do not, however, think that there is any immediate danger of falling behind our competitors. It is important that we focus on raising our own standard of living, which has been increasing since 1992. The report highlights initiatives that must be sustained and areas where additional efforts are needed if the United States is to improve its productivity and the standard of living of its people. These initiatives are listed in the answer to question 3 and appear on page 4 of the report.

Q.6. The Commerce Department is currently reviewing a proposal to collaborate with a Saudi firm on a commercial satellite system capable of producing highly detailed images. Such technology is not yet available on the world market and its necessity to civilian applications is questionable. According to the proposal, a direct data reception and distribution center would be set up in Saudi Arabia. This raises serious questions about how such data would be controlled and the potential impact if it were to fall into the wrong hands.

What is the status of the Commerce Department's review of the eyeglass program?

Why is the U.S considering export approval of spy-quality satellite imagery?

What objections to the "eyeglass" deal were expressed by the State Department, the Defense Department, and the CIA?

What is the Commerce Department's assessment of the potential impact of such sophisticated technology in terms of our commitments to other regional allies, such as Israel, and our efforts to stem the proliferation of dual-use technologies?

If the Saudis have access to this technology, how will the United States prevent improper distribution of the photographs to rogue nations or terrorist groups?

A.6. On May 5, 1994, the Department of Commerce, through the National Environmental Satellite, Data, and Information Service (NESDIS), issued a license to Orbital Sciences Corporation to operate a private remote sensing space system known as Eyeglass. This license was issued under title II of the Land Remote Sensing Policy Act of 1992, one of six such licenses issued under this Act.

The Act requires the licensee to operate the system so as "to preserve the national security of the United States and to observe the international obligations of the United States" and prescribes an interagency process that includes the Department of Defense and the Department of State to develop conditions in the license to ensure compliance. This process has resulted in a Presidential decision directive that established the relevant conditions for these licenses. In accordance with this directive, the Eyeglass license includes the following relevant conditions:

- The license shall at all times maintain positive control of the spacecraft, including safeguards to ensure the integrity of spacecraft operations.
- During periods when national security or international obligations and/or foreign policies may be compromised, as defined by the Secretary of Defense or the Secretary of State, respectively, the Secretary of Commerce may, after consultation with the appropriate agencies, require the licensee to limit data collection and/or distribution by the system to the extent necessitated by the given situation. During those periods when, and for those geographic areas that, the Secretary of Commerce has required the licensee to limit distribution, the licensee shall, on request, make the unenhanced data thus limited from the system available exclusively, by means of U.S. Government-furnished rekeyable encryption on the downlink, to the U.S. Government.
- The licensee shall ensure that all encryption devices used are approved by the U.S. Government for the purpose of denying unauthorized access to others during periods when national security or international obligations and/or foreign policies may be compromised.
- Licensee shall notify NESDIS of any significant or substantial agreement the licensee intends to enter with a foreign nation, entity, or consortium involving foreign nations or entities at least 60 days before concluding such agreement.

Pursuant to the last condition, Eyeglass notified NESDIS on January 11, 1995, of its intent to enter an agreement with a foreign entity, EIRAD Co., Ltd., of Saudi Arabia. NESDIS has forwarded the proposed agreement to the appropriate agencies for their review and expects to have their responses shortly.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM RONALD H. BROWN

Q.1. There were four Export Assistance Centers set up this year with 11 more due in 1995, which due to your assistance includes New York. What were your findings from these current centers? What is the timetable for the opening of the New York center?

A.1. Preliminary information and anecdotal evidence from the Export Assistance Centers (EAC) indicates that the one-stop-shop concept is sound, and, in reality, exporters are receiving high-quality service from the pilot EAC's and their local partners. An internal, interagency assessment of the progress of the four pilot EAC's is underway by the Department of Commerce, the Small Business Administration, and the Export-Import Bank.

The first stage of implementing the pilot EAC's was to go out to the communities and involve partner organizations in the design of the EAC's. Early involvement of local partners has proven to be a critical component in the success of the pilot EAC's. We will hold design meetings in each of the next 11 communities to listen to, understand, and include local needs and capabilities in setting up the EAC's. We expect that the New York Regional Export Assistance Center will be one of the first that we establish in calendar year 1995.

Q.2. What will be done to promote trade to the European Union considering there was a large increase in the trade deficit between 1992–93 ($8.97 billion surplus to a deficit of $1.05 billion in 1993 according to the International Trade Administration of the Department of Commerce)?

A.2. The International Trade Administration (ITA) has developed several new initiatives to take advantage of the growing market opportunities in the European Union (EU). We believe that 1995 and 1996 will show greatly improved trade opportunities for U.S. business as Germany and the rest of Europe recover from a very deep recession. We anticipate U.S. exports to Europe to grow about 3.5 percent this year and 7–8 percent in 1995. This will substantially reduce the bilateral trade deficit.

The Commerce Department is designing a new "European commercial strategy" to respond to the new export opportunities created by the EU's single market and the opening of Eastern Europe. This commercial strategy is premised on the fact that we have a large core of successful exporters doing business only in one or two of the national European markets, such as the United Kingdom. By contrast, U.S. exporters are underperforming in countries such as Germany, Italy, and Sweden. Our strategy is to have our promotion programs identify the U.S. companies that now export to only one or two European markets and to assist them in becoming equally successful in the rest of the markets in Europe. This strategy takes advantage of the experience already gained by U.S. exporters and uses the growing integration of the EU. The potential is huge. If U.S. companies had the same share of the rest of the EU market that they now have in the United Kingdom market, U.S. exports to Europe would be over $50 billion larger. In 1995, we expect to provide additional focus on environmental technologies, aerospace, and software among other exports.

In 1994, ITA established three targeted trade promotion programs in Europe that have produced considerable interest and potential: "Showcase Germany," Poland, and Turkey as "big emerging markets" and the heavy electrical equipment marketing program. These initiatives are enhanced services helping U.S. exporters enter into high opportunity markets in Europe. "Showcase Germany," for example, combines expanded promotion services for the U.S. business community with a new "major customer program" focusing on some of the huge foreign companies that are among Europe's largest purchasers and importers. In 1995, we expect to provide additional focus on environmental technologies, aerospace, and software among other exports.

Q.3. There has been a decrease in low-skilled jobs and a smaller increase in the number of high-skilled jobs which creates a discrepancy in education between the two. How can the current programs be maximized to close the gap?

A.3. See my answer to a similar question submitted by Senator Riegle (Question 2).

COMPETING TO WIN IN A GLOBAL ECONOMY

Summary

RONALD H. BROWN
SECRETARY

U.S. DEPARTMENT OF COMMERCE

SEPTEMBER 1994

This is a shortened version of the report submitted to Congress. Information on how to obtain the full text is located at the end of this report.

UNITED STATES DEPARTMENT OF COMMERCE
Office of the Secretary
Washington D.C. 20230

President of the Senate
Speaker of the House of Representatives

Dear Mr. President and Mr. Speaker:

It is my pleasure to present to the Congress my second Annual Report on the International Competitiveness of the United States.

Last year, I was able to tell you primarily of challenges faced and initiatives planned. This year I am pleased to report a record of solid accomplishment as well as progress made toward pursuing our opportunities in the global market and tackling some of our fundamental economic problems.

Against the backdrop of rapid changes at home and abroad, Americans have rightly been concerned about our country's standing in the world economy. In the late 1980s and early 1990s, many studies sounded alarms about declining competitiveness. More recently, a good deal of this pessimism has been reversed as the United States regained much lost ground and laid the foundation for even more progress in the future.

The bottom line of this report is that the economy is back on track and that prospects in the global marketplace are very bright, but that there are, nevertheless, some daunting challenges ahead. In addition, the message that I would like to convey is that this administration is viewing "competitiveness" in the broadest possible terms, encompassing not just trade policy, but technology, savings and investment, education and training, the health and safety of our citizens, and the cohesion of our communities. In our view, enhancing competitiveness should be a consideration in all of our policies, because the global economy now affects almost every aspect of our way of life.

A summary of our immediate economic position is, as Vice President Gore has said, "What should be up is up, and what should be down is

down." Fundamentally, what "should be up" is private sector job creation and economic growth. The basic objective of all our policies is to improve the U.S. standard of living—something that can be accomplished only if Americans have good jobs. President Clinton set the goal of creating 8 million jobs in four years. Under his leadership over 4 million jobs have already been created in one and a half years—1.7 million more than were created in the four years before he took office. Indeed, our rate of job creation is more than four times the pace per month than for the previous four years.

What "should be down" is unemployment and inflation—and they are. The unemployment rate has fallen from 7.7 percent in June 1992 to near 6 percent at the present time. Despite the strong recovery, consumer prices have increased only 2.6 percent over the past year and producer prices are up only slightly.

This good news is no accident. It has been driven by the administration's success in reducing the federal budget deficit and by new initiatives, including many at the Department of Commerce, in the fields of technology, trade, and economic development. As the President has said, the adoption of his budgets "will give us three years of deficit reduction for the first time since Harry Truman was the President of the United States. ... We have the basis for the first growth in America in 30 years that is led by investment and that has no inflation..."

The Department of Commerce is deeply committed to helping U.S. companies become more competitive in the global economy. As we are proving every day, from the Pacific Rim to Latin America to the European Union, American workers are the most productive in the world, and American products, services, and technology are in increasing demand around the globe. We are not afraid to compete with anyone, at home or abroad. As President Clinton has stated, "Open and competitive commerce will enrich us as a nation....it spurs us to innovate. It forces us to compete. It connects us with new customers. It promotes global growth without which no rich nation can hope to grow more wealthy."

We recognize the primacy of the private sector in creating economic growth. Government's role is to work with industry, labor, and academia to create a healthy, sustainable foundation on which U.S. companies are able to compete and win in the global economy.

For example, we are working in close partnership with the private sector in developing new cutting-edge technologies, in opening new markets and promoting exports, in building competitive communities, and in supporting the creation of a National Information Infrastructure for the 21st century. The following report discusses our efforts and our considerable accomplishments in each of these areas.

With opportunities expanding all around us, we recognize the challenge of making certain that all of our citizens benefit from our progress in the world economy. We are bringing new, future-oriented business into the urban core. We are encouraging the expansion of business formation for minority entrepreneurs and other central city residents. We are helping business in the inner city expand into growth industries and to export products to other countries.

As this report makes clear, there is still much to do. We face great challenges in boosting our investment levels, in improving our secondary education systems, in training our workers, and in opening foreign markets. But America has been very much on the move in the world economy in the first eighteen months of the Clinton Administration, and we should be proud of our achievements.

I would like to express my appreciation to Chairman Donald W. Riegle and the Senate Banking, Housing, and Urban Affairs Committee for authoring the legislation which mandates these annual reports. They have done our country a great service.

I look forward to continuing to work with you for a strong, highly competitive America.

Ronald H. Brown

Ronald H. Brown
Secretary of Commerce

INTRODUCTION

Section 206 of the Export Enhancement Act of 1992 requires the Secretary of Commerce to submit to the Congress a report on the international economic position of the United States. This report is organized in two parts. Part I addresses the state of U.S. economic competitiveness and the specific recommendations required by the Congress. Part II responds to the remainder of the legislative requirements by focusing on the efforts of the Department of Commerce to improve competitiveness and raise living standards.

There is no more important subject. The changing world economy now affects every area of our lives. Our trade, our capital markets, our jobs, our communities are linked to conditions and policies abroad. There are new opportunities everywhere—with our traditional trading partners, with emerging markets, and the billions of new consumers entering the world economy. At the same time, the international marketplace is becoming more competitive every day.

We are in better shape to compete than we have been in many years. The U.S. economy now enjoys sustainable growth and continued job creation. Under President Clinton's leadership, the federal budget deficit is declining dramatically; new programs are on line to bring the most advanced technology to our firms; and innovative approaches to improve training programs for our workforce have been instituted. We have achieved significant trade liberalization around the world and established an aggressive National Export Strategy to take advantage of new market openings. There is a renewed emphasis on education; health care has become one of our highest policy priorities; and our corporate sector is investing in new plant and equipment at record levels. In recent years, the United States has accounted for three-quarters of the economic growth in the industrial world and almost all of the new job growth. More than any of its major competitors in the world economy, America is on the move.

Competitiveness has historically been discussed in terms of trade deficits and surpluses, either overall or by industrial sector. These are critical benchmarks because our productivity, our incomes, and our standard of living depend on our ability to compete in global markets.

But much more than international trade is relevant to how we live and perform as a nation. Indeed, the ultimate goal of the administration's efforts to strengthen U.S. competitiveness is to improve the standard of living of our citizens, to create more opportunity for all Americans, and, above all, to produce good jobs.

The strategy of the Department of Commerce is to improve national competitiveness by creating tools to facilitate private sector activities that raise living standards for us all. The strategy underlies all of the Department's efforts: identifying new avenues for technology development and diffusion; launching creative approaches to trade promotion; working with the private sector to assess the ability of critical sectors to support future economic and national security needs; establishing a forward-looking information infrastructure for the economy taking form around us; protecting the intellectual property on which that new economy is based; developing an innovative approach to "competitive communities"; providing the private sector with better business information; and so much more. The common denominator of these activities is that they promote and extend private sector excellence and allow opportunities to be created for the American people. If we do these things, a higher standard of living, new jobs, and better trade performance will follow.

In the past few years, many reports have been written in the U.S. Government and by private groups that take an expansive perspective on competitiveness. They point to the importance of education, training, public investment, the structure of our capital markets, labor-management relations, health care, environmentally sustainable development, and other issues. This broad view is the best way to understand what is happening in our society and what competitiveness is all about.

The fact is that the United States, like so many other nations, is undergoing dramatic change. In the midst of such a transformation, the most important goal we can have is a productive and adaptive private sector that will raise living standards and create jobs and other opportunities for all our citizens.

This means a society in which workers and their families are secure in the face of change. As technology and trade transform the workplace, our citizens must have opportunities to obtain new skills, to move to new jobs, and to shed insecurity about their health coverage or the availability of their pension plans. Reducing insecurity while maximizing mobility in the changing workplace is the preeminent challenge to meeting the goals of a more competitive economy and an improved quality of life for our citizens.

This report will discuss the progress we have been making, but it will also argue for removing any complacency that we have tackled adequately all of our fundamental problems. We have made a good start. . . but only that. There are major challenges ahead.

Competing in a Global Economy

Part I ■ Competing in a Global Economy

– 1 –

The U.S. Economy Has Shown Renewed Strength.

Recent developments in the economy with respect to growth, living standards, inflation, and productivity have been quite favorable. In fact, the Clinton Administration has laid the basis—for the first time in 30 years—for growth that is led by investment in an environment without inflation. By continuing the initiatives launched these past 18 months and pressing forward with new programs and approaches to our economy, these positive developments can be extended into long-term gains in U.S. competitiveness.

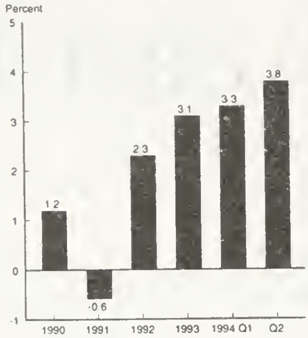
Economic Growth. For the first time in many years, the U.S. economy is enjoying sustained, non-inflationary growth. In 1993, the U.S. economy as measured by real gross domestic product (GDP) grew 3.1 percent, and a similar expansion is expected in 1994. This growth compares favorably with the average annual growth rate of 1.0 percent in the period 1990–92. (See Figure 1.)

Employment. Unemployment has been too high for too long, but is finally coming down. From 1989 to 1992, the civilian unemployment rate averaged 6.2 percent annually and was as high as 7.7 percent in June 1992. The unemployment rate fell to 6.4 percent by the end of 1993 and is currently 6.1 percent. (See Figure 2.) More than 4.1 million new jobs have been created since January 1993. Ninety-three percent of job creation has been in the private sector, versus nearly 50 percent in the previous four years. This overall rate of job creation is well ahead of President Clinton's goal of 8

Figure 1

U.S. Real GDP Growth

Economy Improved After the 1991 Slump



Source: Bureau of Economic Analysis

Figure 2

Employment and Unemployment

Employment Has Improved

Source: Bureau of Labor Statistics

Note: Unemployment series was revised in 1994 and is not directly comparable with prior years.

million jobs in four years. Already 1.7 million more jobs have been created than were created in the previous four years.

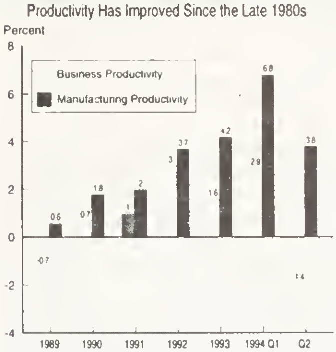
Productivity and Living Standards.

Productivity growth is key to our continued economic prosperity. There has been some good news in the past two years. Productivity—real output per hour worked—for the entire private sector of the economy gained 1.6 percent last year after a 3.0 percent gain in 1992, and was down at a 1.4 percent rate for the second quarter of 1994. Despite the recent decline, the overall rate of growth is quite favorable compared with an annual average gain of only 0.6 percent for the years 1987 through 1991. Recent productivity growth in the manufacturing sector has been strong. In the second quarter of 1994, productivity in manufacturing rose at a 3.8 percent rate after a 6.8 percent gain during the first quarter. In 1993 manufacturing productivity rose 4.2 percent. (See Figure 3.) This compares favorably

Figure 3

Growth in Output per Hour Worked

Productivity Has Improved Since the Late 1980s



Source: Bureau of Labor Statistics

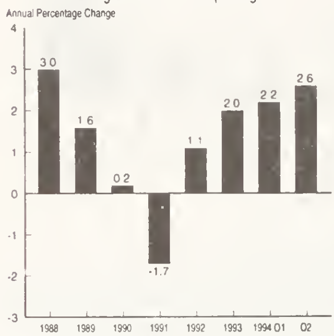
with the 1.6 percent annual increase from 1987 through 1991.

Growth in GDP per capita, as a consequence of the economic recovery and the improvement in productivity, was 1.1 percent in 1992 and 2.0 percent in 1993, after average annual growth of only 0.8 percent from 1987 through 1991. (See Figure 4.)

Figure 4

Per Capita Gross Domestic Product

Living Standards Are Improving

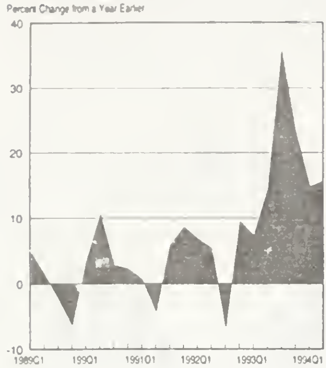


Source: Bureau of Economic Analysis

Corporate Sector Progress.

American companies have been restructuring their operations, cutting costs, and adopting new technologies at a phenomenal rate—and much faster than their foreign competitors. Corporate profits increased 20 percent in 1993 and are up 24 percent from 1991. (See Figure 5.) Increases in profits are critical since they are a major factor in stimulating and financing increased investment. Indeed, business investment in plant and equipment also improved in 1993, rising 12.5 percent in real terms after a 2.0 percent gain in 1992. (See Figure 6.) Plant and equipment spending is now 12 percent of GDP, a postwar record. The number of business failures declined 12 percent in 1993. Failures in the first quarter of 1994 were down 43 percent (using value of current

Figure 5
Corporate Profits
Corporate Profits Continue to Increase

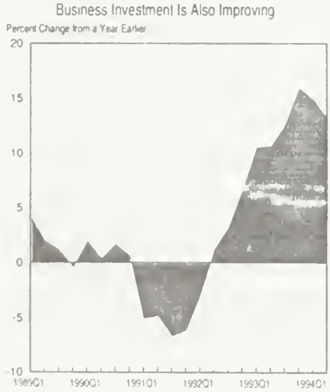


Source Bureau of Economic Analysis

liabilities of the failed businesses as a measure) from a year ago.

Lower Inflation. The U.S. economy has had low inflation despite the strong recovery. Consumer prices increased 3.0 percent in 1993 and 2.6 percent during the year before

Figure 6
Real Business Fixed Investment
Business Investment Is Also Improving



Source Bureau of Economic Analysis

July 1994. There has been even less inflation in producer prices, which rose 1.2 percent in 1993 and only 0.6 percent from a year ago. (See Figure 7.)

Figure 7
Consumer and Producer Prices
Inflation is Under Control

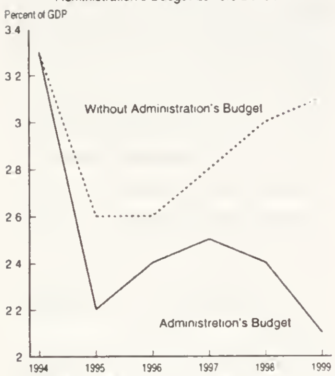
Source U.S. Department of Labor

Administration Policies

The recent strengths of the U.S. economy have been fostered by the administration's policies in several areas.

Deficit Reduction. Much of the good news on economic growth and job creation has been driven by success in reducing the federal budget deficit. (See Figure 8.) In 1993, the President requested and the Congress approved a five-year $500 billion budget reduction package. These budgetary changes will reduce the budget deficit from 3.3 percent of GDP this fiscal year to just over 2 percent in 1999. Without the President's program, and the savings realized by extending the constraints on spending growth, the deficit would decline only slightly relative to GDP.

Figure 8
Federal Budget Deficit
Administration's Budget Lowers Deficit



Source: Office of Management and Budget

Investment in Technology. Initiatives have been put into place that are strengthening our technology base and infrastructure. The shift in emphasis from military to civilian research and development is exemplified by several encouraging trends: a shift toward more equal funding of civilian and defense research and development (civilian is up to 47 percent of total R&D spending in the President's budget for fiscal year 1995 compared with 41 percent in 1993); the expansion of the Advanced Technology Program; and increased priority among agencies to devote more resources to cooperative research and development agreements with industry as opposed to strictly governmental research. All of these initiatives are enhancing our civilian technology base. The National Information Infrastructure and the network of manufacturing extension centers will also expand the flow of information and diffusion of innovative technologies, thereby boosting long-term productivity.

Trade Liberalization. We have made tremendous progress in the first year and a half of the Clinton Administration in opening world markets for our goods and services. The North American Free Trade Agreement has begun to take economic hold. U.S. exports to Mexico shot up 17 percent in the first half of this year, reversing a weak performance last year. Mexico and Canada alone accounted for nearly half the growth of global U.S. exports in the first half of 1994.

Among some of the fastest growing exports are those that realized immediate Mexican duty elimination under the agreement, such as semiconductors, office equipment, and instant print film. The phasing out of nontariff barriers in the auto sector allowed the Big Three auto makers to sell as many vehicles in Mexico in the first quarter of 1994 as they had in all of 1993.

URUGUAY ROUND BENEFITS

The expansion of trade resulting from the Uruguay Round will boost U.S. productivity and average real wages, increase consumer choice and spending power, raise living standards, and hone economic competitiveness.

All told, when fully implemented the Uruguay Round should:

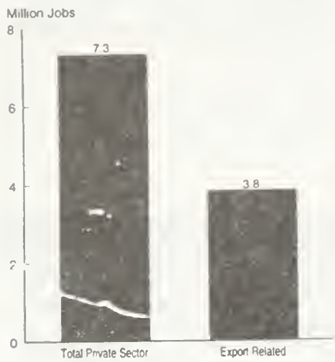
- **add as much as $100 billion to $200 billion to the U.S. gross domestic product annually;**
- **raise total U.S. employment by hundreds of thousands of jobs;**
- **save individual U.S. consumers hundreds of dollars annually in lower costs of food and other important items, many of which loom large in the budgets of lower income households; and**
- **boost average labor productivity, real wages and living standards in the United States and around the world.**

A Uruguay Round agreement was finally reached with other members of the General Agreement on Tariffs and Trade and is before Congress. The agreement will provide substantial benefits to Americans for many years to come. (See box.) Indeed, export growth has been a major factor in U.S. job growth since 1986. (See Figure 9.)

Figure 9

Export-Related and Private Sector Employment

Export-Related Accounts for Over Half Job Growth Between 1986 and 1992



Trade Promotion. Last September, President Clinton unveiled the National Export Strategy—the administration's comprehensive plan to dramatically upgrade and coordinate U.S. Government export promotion and trade finance programs. This aggressive new export strategy was developed by the Trade Promotion Coordinating Committee (TPCC), an interagency task force of 19 federal agencies chaired by Commerce Secretary Brown. The plan recommends a streamlining of programs to boost U.S. exports—a more effective approach that will match the efforts of our major competitors. Already, the TPCC's implementation of this plan has yielded reduced export obstacles, aggressive government advocacy, improved export financing, and upgraded service at our domestic and overseas offices. These coordinated efforts are helping win important overseas sales and are enhancing the international competitiveness of American exporters. Building upon these substantial accomplishments, ambitious new interagency initiatives are being developed by the TPCC for the next year.

Workforce Investment. Training and education are fundamental to sustained economic growth and continued job creation. Initiatives in education and training will bear sustained economic benefits in the coming years. The President has signed the *Goals 2000: Educate America Act* which embodies in law eight national education goals and provides for the development of challenging curriculum and assessment standards in academic subject areas. The President's budget request for fiscal year

TRADE PROMOTION RESULTS

President Clinton's and Secretary Brown's advocacy on behalf of U.S. businesses competing for foreign government procurements has already borne fruit:

- **In Saudi Arabia's purchase of aircraft from the Boeing Co. and McDonnell Douglas Corp., valued at $6 billion;**
- **In Saudi Arabia's $4 billion contract for telecommunications network modernization awarded to AT&T; and**
- **In Brazil's award of the $1.5 billion SIVAM rain forest protection contract to the Raytheon Company, a defense contractor.**

The Commerce Department, Export-Import Bank, and Small Business Administration have opened the first four Export Assistance Centers in Baltimore, Miami, Chicago and Long Beach (Calif.)—with 11 more centers planned as part of a nationwide network providing support for smaller businesses to compete in export markets.

TOWARD AN ADAPTABLE WORKFORCE

Building a more adaptable workforce is a key element of our economy's flexibility in the face of the accelerated pace of technological advancement. Its success depends on five principles of enhanced education and training.

- **Improve the quality of initial education.**
- **Reduce early departures from school.**
- **Streamline the school-to-work transition.**
- **Move from passive unemployment systems to active "reemployment" systems.**
- **Promote lifelong learning and high-performance workplaces.**

1995 provides $700 million in school improvement funds for states that present plans for systemic reform to enable their students to meet these high standards. The School-to-Work Opportunities Act, which the President signed into law in the Spring of 1994, supports states in their efforts to design and implement coherent strategies to prepare young people with the knowledge, skills, and experiences to make a smooth transition to good jobs and further learning. The act authorizes $300 million in fiscal year 1995 as seed money to state and local school systems to develop school-to-work transition programs. But this program is not waiting for fiscal 1995 to begin. Through the efforts of the Departments of Labor and Education, some $100 million has been made available for the program in fiscal 1994.

President Clinton has also established the National Service Program, which will provide students with opportunities for community service and the ability to earn money for college. The administration has expanded the Head Start program to boost early childhood education for the disadvantaged.

The administration has proposed the Reemployment Act of 1994 to assist in transforming our passive unemployment system into an active reemployment system. This initiative will provide a comprehensive array of reemployment services, training, and income support for permanently laid-off workers. It also will facilitate creation of one-stop career centers to serve as common points of access for all job seekers to obtain employment, education, and training information and services.

The administration is committed to encouraging more companies to develop state-of-the-art, high-performance workplaces. In pursuit of this goal, the Labor Department's Office of the American Workplace is working with the National Institute of Standards and Technology to create higher-wage, higher-skill jobs, to integrate new technology with innovative work systems and human resource policies, and to ensure that workers and unions are involved in the design, development, and deployment of new technology. These efforts are part of the administration's commitment to principles that will enhance the ability of America's labor force to adapt to global economic change. (See box.)

The National Performance Review. Government must also become more competitive, keeping pace with reforms and restructuring in the private sector. Last year, Vice President Gore initiated the National Performance Review with the objective of modernizing and streamlining government and making it more efficient. The benefits will be a government that is adapted to the needs of the 21st century and ready to play its part in partnership with business and labor to raise the living standard of the American people.

Other Major Initiatives. The Clinton Administration has proposed a number of other initiatives that will help keep the U.S. economy among the world's most flexible. Key among these is health care reform, which will ensure that all citizens have access to medical care even should they change or lose their jobs. Welfare reform legislation will increase the ability of welfare recipients to find jobs, and the administration's crime bill will help provide a safer living and working environment. The combination of the recent improvement in the economy and the administration's initiatives, both enacted and proposed, gives strong reason for optimism about economic performance and living standards in America.

– 2 –
There Is More Work To Be Done.

While a strong economic recovery sets the stage for sustained economic growth, other structural changes in the U.S. economy threaten our international competitiveness and essential improvements in our standard of living.

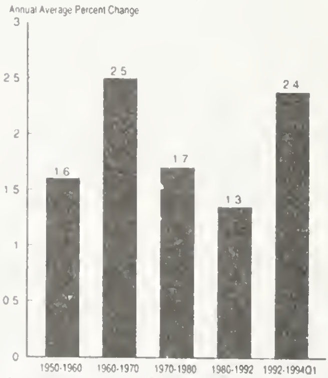
In assessing how competitive we are, it is important to examine the position of individual industries in the world market, and we must also track our trade balances. But much more is at stake. Indeed, the best definition of competitiveness comes from the *Report of the President's Commission on Industrial Competitiveness* (1984), which states:

> *A nation's competitiveness is the degree to which it can, under free and fair market conditions, produce goods and services that meet the test of international markets while simultaneously expanding the real income of its citizens. Competitiveness at the national level is based on superior productivity performance and the economy's ability to shift output to high productivity activities which in turn can generate a high level of real wages. Competitiveness is associated with raising living standards, expanding employment opportunities, and the ability of a nation to maintain its international obligations. It is not just a measure of the nation's ability to sell abroad, and to maintain a trade equilibrium.*

Comparisons of competitiveness must, therefore, take into account both where the United States has been as a nation (as was done in section 1) and where the country stands vis-à-vis other nations. Both sets of comparisons provide evidence of a range of competitive challenges that are changing and highly dynamic.

Living Standards. The longer-term trends in living standards indicate that growth has slowed significantly in the 1970s and 1980s. Real per capita GDP growth was 2.1 percent per year between 1955 and 1973, but only 1.3 percent per year since then (Figure 10).

Figure 10
Real per Capita GDP
Growth Improving

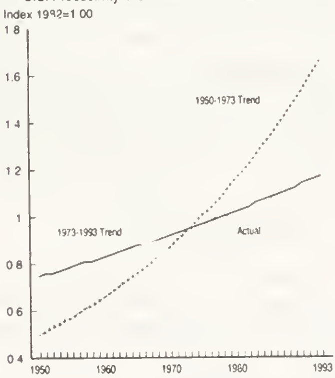


Source: Bureau of Economic Analysis

These are the trends that must be changed by a combination of private initiatives and government policies. The following sections discuss the major factors that influence per capita GDP and the policies necessary to reverse these long-term trends.

Low Growth in Productivity. Growth in productivity, defined as real output per hour worked, is fundamental to increases in the standard of living. Despite dramatic improvements in productivity in this recovery, the longer term trend is weak. From the year 1950 through 1973, productivity grew at an average rate of 2.8 percent per year. And yet from 1973 through 1993, productivity grew only 1.0 percent annually. (See Figure 11.)

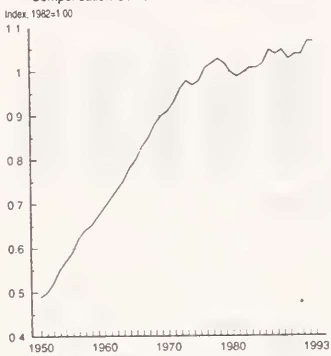
Figure 11
Output Per Hour Worked
U.S. Productivity Growth Has Slowed Since 1973



Source Bureau of Labor Statistics

Without increasing our ability to produce more per person, our economic growth will stagnate. Recent productivity changes indicate some hopeful signs, but we must take steps to assure that the trends underlying these changes have been altered fundamentally.

Figure 12
U.S. Real Compensation Per Hour
Compensation Gains Have Slowed Since 1973



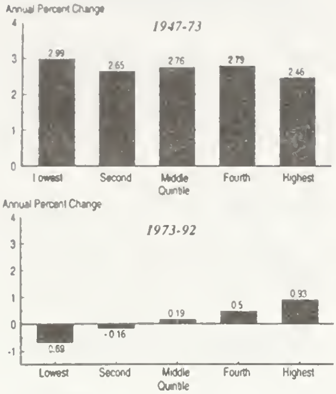
Source Bureau of Labor Statistics

Labor Compensation Lags. The lack of growth in productivity underlies an alarmingly poor performance in workers' hourly compensation. From 1950 through 1973, hourly compensation—including both wages and benefits and after adjusting for inflation—increased an average of 3.0 percent per year. However, since 1973, hourly compensation has grown by only 0.4 percent per year. (See Figure 12.)

Also disconcerting has been the disparity in income gains by various groups. Prior to 1973, income gains were rather widely shared among Americans. However, since 1973, there has been considerable unevenness in family income growth. (See Figure 13.) Those on the low end of the income distribution have lost considerable ground during the past 20 years.

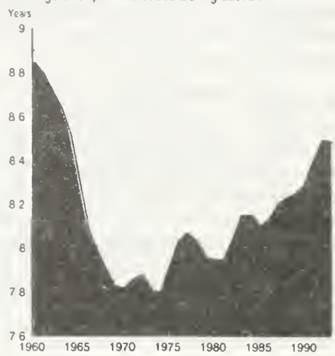
Investment and Capital Stock. The quantity and quality of capital stock per worker—including both equipment and structures—are fundamental determinants of productivity and, hence, the standard of living. More efficient methods of production and new products typically require new equipment. Growth in investment per worker has

Figure 13
U.S. Mean Family Income
Disparity in Family Incomes Has Grown Since 1973



Source Census Bureau

Figure 15
Average Age of Capital
Age of Capital Increased During Last 20 Years



Source. Bureau of Economic Analysis
* Fixed non-residential private capital

been directly associated with higher capital per worker and the pace of productivity growth. (See Figure 14.)

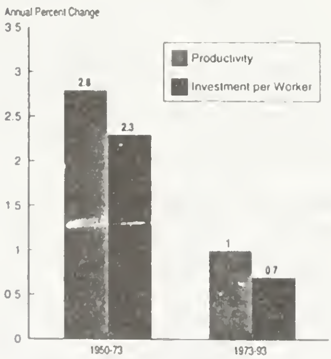
One measure of the quality of the capital stock is its age. Here there is cause for concern. From World War II onward, there was a steady decline in the average age of the U.S. capital stock. This favorable trend in the age of capital was reversed in the early 1970s. Since then, the average age has been increasing. (See Figure 15.)

From 1950 to 1983, capital per worker grew by 1.5 percent. In the 1980s, growth dropped off to only 0.6 percent. Since 1990, capital per worker has grown by 2 percent a year, but it will take some years, even at this higher rate, to reach the levels that would have existed had growth not slowed in the 1980s. (See Figure 16.)

In large part, the recent improvement in the stock of capital reflects higher levels of investment. Investment per worker rose 11 percent last year, after a decade of stagnation.

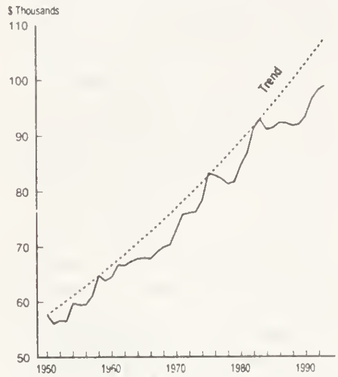
Government investment also plays an important role in boosting productivity. Government-owned capital stock (such as highways and airports) constitutes in large part the infrastructure necessary to the efficient operation and growth of our economy. This capital stock has been increasing relative to the number of workers in recent years. However, these increases must be

Figure 14
Growth in Investment per Worker and Productivity
Growth Has Slowed



Source Bureau of Economic Analysis and Bureau of Labor Statistics

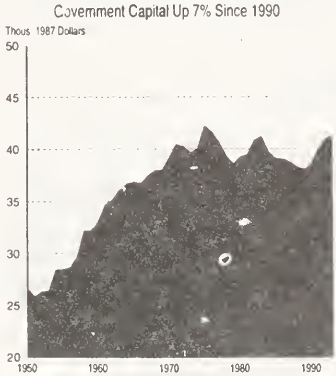
Figure 16
Gross Capital Stock per Worker
Stock Per Worker Slowed in the 1980s



Source: Bureau of Economic Analysis

measured against the steep declines experienced in the mid-1970s and for most of the 1980s. Overall, and in spite of recent gains, there has been virtually no growth in government capital per worker for the past 20 years. We must build on the recent growth in government-owned capital stock to make a dramatic improvement in productivity. (See Figure 17.)

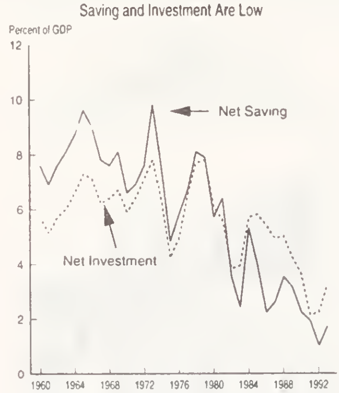
Figure 17
Government Capital Per Worker
Government Capital Up 7% Since 1990



Source Bureau of Economic Analysis and Bureau of Labor Statistics

The Problem of Low Saving. Underlying the slow growth in capital stock per worker and the increasing age of our capital stock is inadequate national saving. Net national saving is defined as gross saving by all sectors of the economy less the depreciation on fixed capital. This is the amount of saving that is available to increase the capital stock. Net national saving was only 1.9 percent of GDP in 1993 and has averaged 1.8 percent since 1990. By comparison, this ratio was 8.1 percent in the 1960s, 7.2 percent in the 1970s, and 3.7 percent in the 1980s. This recent level of saving cannot itself sustain the investment needed to produce long-term productivity growth and economic expansion without continued or increased borrowing from abroad, with accompanying current account deficits. (See Figure 18.)

Figure 18
Net Saving and Investment
Saving and Investment Are Low



Source Bureau of Economic Analysis

Net fixed investment (gross investment in equipment and structures less depreciation) has also been declining with respect to GDP. From about 6.5 percent of GDP in the

1960s and 1970s, net investment slipped to 5 percent in the 1980s and under 3 percent in the 1990s. Reduced national saving makes domestic investment that much more difficult.

If domestic saving is inadequate, foreign capital inflows typically meet only some of the demands of a growing economy and investment suffers. Foreign investment can make some contribution to economic growth when constraints on the availability of domestic capital would otherwise bind. During the 1980s, when net investment was higher than net saving, the United States was importing foreign capital. This practice, however, has its costs.

For example, the United States has become a debtor nation with consequent vulnerability to the preferences of foreign creditors. (See Figure 19.) Another consequence of becoming a net debtor nation is that the future stream of interest and dividend payments will go to foreign citizens instead of Americans. That will limit growth in domestic income and living standards.

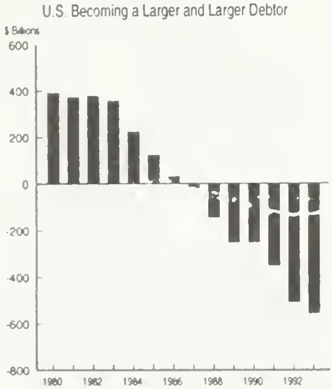
International Trade Performance. The United States has a long-term trade balance problem. Since 1976, the United States has continuously run merchandise trade deficits. Between 1980 and 1987, the level of the trade deficit increased dramatically from $19.4 billion to a peak of $152 billion. While trade imbalances do not imply economic weakness, continuing deficits must be financed by foreign borrowings, which as noted earlier, have led the U.S. to become a net debtor nation.

The U.S. balance of trade has deteriorated significantly during the past two years, reflecting the recent strengthening in our economy relative to those of other industrialized countries as well as the continuing saving/investment imbalance referred to earlier. The balance of trade in goods and services slipped to a deficit of $75.7 billion in 1993, from a $27.9 billion deficit in 1991. Exports grew at a 5.1 percent rate, in nominal terms, during the two-year period, while imports rose at an 8.5 percent rate. (See Figure 20.)

Figure 19

U.S. Net Investment Position

U.S. Becoming a Larger and Larger Debtor

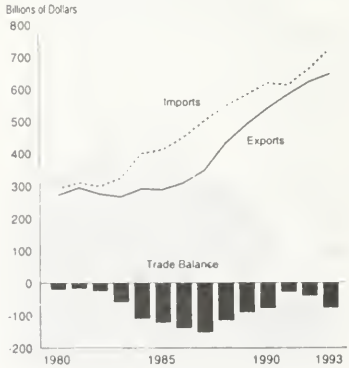


Source Bureau of Economic Analysis

Figure 20

U.S. International Trade in Goods and Services

The Trade Balance Has Worsened Since 1991

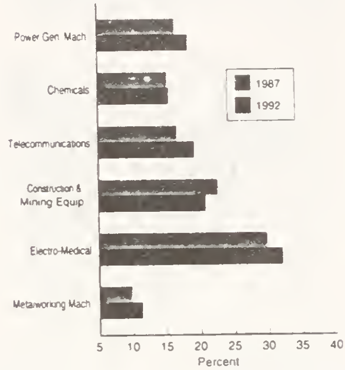


Source Bureau of Economic Analysis and Census Bureau

Figure 21
U.S. Shares* of World Total & Mfrs. Imports
Some Recovery in U.S. Share After 1987

Source United Nations, IMF
*Shares of world imports excluding U.S. imports

Figure 22
Share of Selected World Product Imports
U.S. Improves in Majority of Products Since 1987



Source United Nations

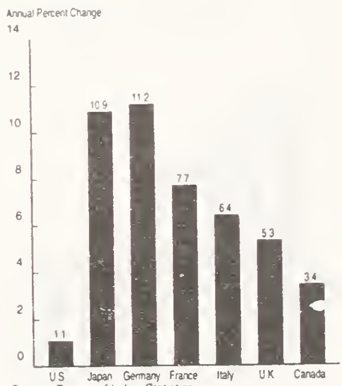
Recent slow growth in U.S. exports does not imply any loss of U.S. competitiveness in world markets. On the contrary, U.S. export competitiveness appears to be increasing. One indicator is the U.S. share of the world market. This share had declined during the 1970s and most of the 1980s. Since 1987, our share has improved slightly. (See Figures 21 and 22.)

Another bright spot for U.S. exports has been our performance in unit labor costs, which has greatly enhanced our price competitiveness. As shown in Figure 23, unit labor costs in the United States have risen more slowly than those of our trading partners, thus increasing our competitiveness.

Export growth has been slow in 1993 and 1994 because foreign economic performance has been weak. Imports have been strong because the U.S. economy is growing, unemployment is down, and people are buying goods and services. In 1994 continued strong U.S. economic growth and slow growth in the most industrialized countries will mean an even larger trade deficit. As Europe and Japan recover, however, exports will increase and the deterioration in the trade balance will slow or reverse. But unless there are fundamental changes in underlying trends, a large trade deficit will remain.

One particularly bright spot in our trade performance has been services, led by

Figure 23
Unit Labor Costs (in Dollars)
U.S. Costs Rise Slowest Between 1985-1993



Source Bureau of Labor Statistics

Figure 24

U.S. Trade Balances for Goods and Services

Goods Deficit Worsens as Services Surplus Grows

Source Bureau of Economic Analysis
Census Bureau

travel services, royalties. and business, professional, and technical services. In 1993, the trade balance in services was in surplus by $56.9 billion, up from $45.9 billion in 1991 and essential balance in the mid-1980s. Most categories of services exports have been growing at a faster pace than foreign growth and can be expected to increase even more rapidly as foreign countries begin their economic expansions. (See Figure 24.)

Unemployment. At 6.1 percent of the labor force, unemployment is still too high. Part of the sizeable gains in productivity that have been achieved in recent years has occurred because businesses have been cutting staff. Initial unemployment claims, particularly in manufacturing, have remained high into 1994—350,000 or more per week—suggesting that there is still considerable restructuring and consequent dislocation in the labor market. The duration of unemployment is higher now than at the bottom of the recession, and manufacturing employment has risen slightly since the end of the year. (See Figures 25 and 26.)

Figure 25

Average Duration of Unemployment*

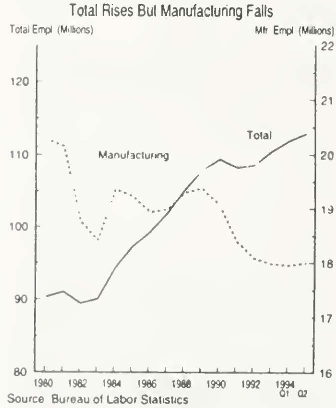
Length of Time Unemployed Has Increased

Source Bureau of Labor Statistics
* The Definition of Unemployed Workers Changed in 1994

Figure 26

Total & Manufacturing Employment, 1980-94

Total Rises But Manufacturing Falls



Source Bureau of Labor Statistics

– 3 –
The Objective Of All Our Policies Is To Improve The U.S. Standard Of Living And To Create More And Better Jobs.

In all the discussions concerning international economic competitiveness, we should not lose sight of the basic objectives—to improve the U.S. standard of living, to allow us to earn more, to buy more, and to live more satisfying lives. The most critical part of this challenge is to create more jobs, which pay higher wages, and which lead to more satisfying work. Our ability to compete in the international marketplace is a crucial element in the way we live—especially the jobs we retain and create. However, if we are to meet our larger goals, we must institute a wide range of policies that go beyond trade policies *per se*. Policies on issues such as education, health care, and environmental quality are equally critical. In fact, the changes necessary to improve our living standards—higher levels of saving and investment, improvements in the education system, a more dynamic technological base, a more open global trading system, a safer and healthier workforce, and environmentally sustainable economic growth—would also lead to a better export performance.

Promoting Change. The only way to tackle these fundamental problems is to focus on the change needed to bring about additional economic growth. Change is fundamental to raising our competitiveness and standard of living. Rather than avoiding it or trying to minimize it, we should be encouraging it. We need to find ways to facilitate change—to remove roadblocks and institutional hurdles. We must make the process easier and reduce the social costs.

– 4 –
We Must Compete In A Global Economy.

How well has the United States done in comparison with other nations? For the most part, the data indicate that the United States has the highest productivity and standard of living, but other countries have had somewhat more rapid rates of growth. This pattern has been particularly true with respect to the developed countries, but now is also true with respect to the Big Emerging Markets (section 5).

It is important to remember that, over the course of history, most countries' living standards tend to improve. The United States is not in a race with other nations in the sense that one wins at the expense of another. Following World War II, the U.S. policies were designed to restore economic vitality to our allies and former enemies. The policies had the desired effect and, at the same time, created markets for U.S. business. Likewise, the many successful efforts during the past half century to lower

Figure 27

World Gross National Product

World Economy Continues to Grow

Source CIA, Handbook of Economic Statistics

tariffs and other barriers to trade have helped all countries improve their living standards. (See Figure 27.) These trends continue. For example, initial experience with NAFTA indicates that trade has increased with both Mexico and Canada.

Living standards in the United States, as measured using purchasing power parities,[1] have been improving less quickly than in other G-7 nations.[2] Since 1950, U.S. real GDP per capita has risen only 1.8 percent per year, while in Japan the rise has been 5.2 percent per year and in Germany, 3.1 percent. France and the United Kingdom have had growth rates of 3.1 percent and 2.1 percent, respectively.

Even though the gap in living standards between the United States and other industrial countries has been closing steadily over the past four decades, the United States still enjoys a higher standard of living than the other major industrialized countries. (See Figure 28.)

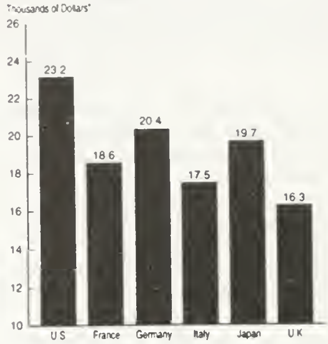
Comparisons using other indicators that influence living standards identify areas where our performances appear strong and areas where we are lagging.

Positive Indicators. In many respects, the performance of the U.S. economy appears to be exceeding that of our major trading partners. Our performance in the area of employment has been exceptionally strong. Of the G-7 countries, only Japan has had a faster rate of job growth since 1987 (Figure 29). The U.S. unemployment rate is lower than all except Japan. (See Figure 30.)

Figure 28

GDP Per Capita, Selected Countries, 1992

U S Standard of Living is the Highest

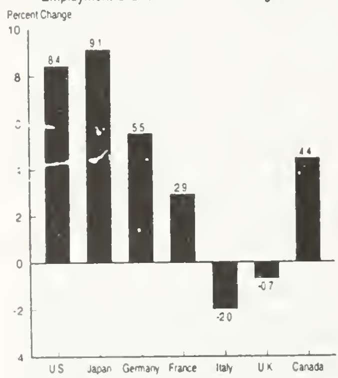


Source OECO
* In Purchasing Power Parities

Figure 29

Job Creation, 1987-1993

Employment Growth in U.S. Second Highest

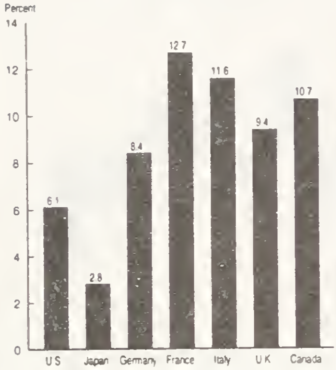


Source U S Dept of Labor, National sources

[1] Purchasing power parities are a generally accepted measure of the buying power of foreign currencies in their home markets relative to the buying power of the U.S dollar in America They measure how much it costs to buy a standard basket of goods and services in different countries relative to how much the same basket costs in the United States

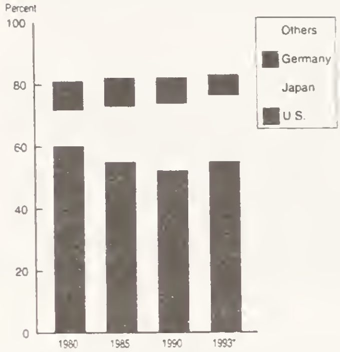
[2] The Group of Seven (or G-7) major industrialized countries are the United States, Japan, Germany, France, Italy, the United Kingdom, and Canada.

Figure 30
Rates of Unemployment, 1994:Q2
U.S. Rate Second Lowest



Source: OECD

Figure 32
Shares of New U.S. Patents Issued
U.S. Share Recovers



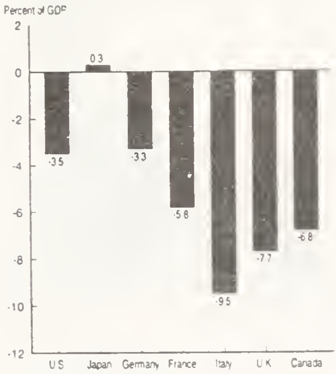
Source: U.S. Patent & Trademark Office
* 1993 Fiscal Year

Although our budget deficit is still large, as a percentage of gross domestic product, it ranks among the lowest of the G-7 countries. (See Figure 31.)

Another positive sign is the distribution of new patent filings. Nearly 60 percent of new U.S. patents issued in fiscal year 1993 were by Americans. (See Figure 32.)

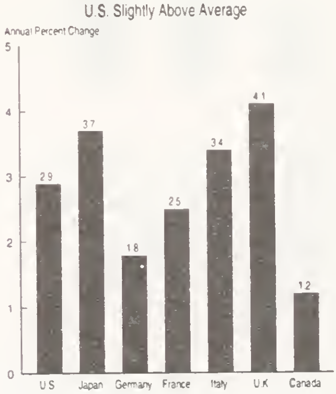
A somewhat ambiguous comparison is manufacturing productivity. Recent figures from 1985 through 1992 put the United States in a middle area compared with other G-7 countries. (See Figure 33.) While

Figure 31
Budget Balances as a Percent of GDP, 1993
U.S. Deficit Among Lowest as Share of GDP



Source: OECD

Figure 33
Manufacturing Productivity, 1985-1993
U.S. Slightly Above Average



Source: Bureau of Labor Statistics

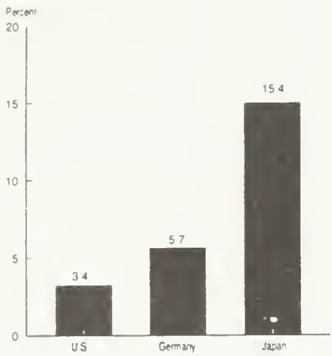
this is an improvement from earlier years, the United States needs to raise its productivity growth both in absolute and relative performance if it to improve its rates of growth in standard of living and worker compensation.

U.S. Performance Lags in Some Areas. In the crucial area of saving and investment, the United States lags considerably behind other industrialized nations. (See Figure 34.) The United States has not only experienced a decline in net saving and investment relative to GDP, but also devotes fewer resources to saving and investment than other nations.

Figure 34

Net Investment as a Percent of GDP, 1993*

U.S Investment Is Lower Than Others



Source OECD National Accounts

* Japanese data are for 1992

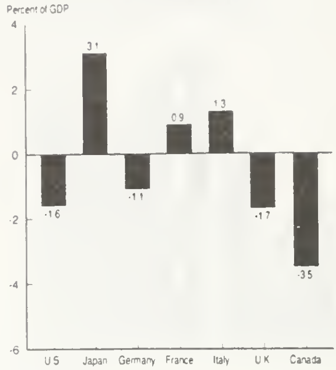
Current account deficits are not independent of our net national savings rate. As Figure 35 indicates, our current account deficit as a percent of gross domestic product places us near the bottom when compared with other countries.

In education, there is growing concern that today's students—tomorrow's workers—are not getting the education they will need in a more technical world. For example, American 13-year-olds continue to score lower on international science and math proficiency tests than their Asian and European counterparts. (See Figure 36.)

Figure 35

Current Account Balance Percent of GDP, 1993

U S Deficit Among Highest

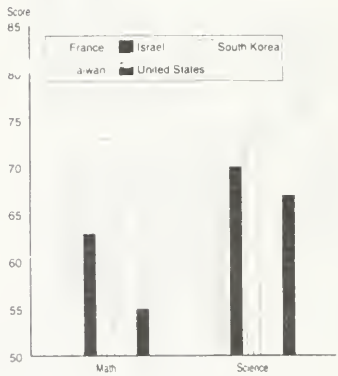


Source OECD

Figure 36

Math and Science Proficiency Test Scores

U.S. 13-Year-Olds Score Low on Int'l. Tests



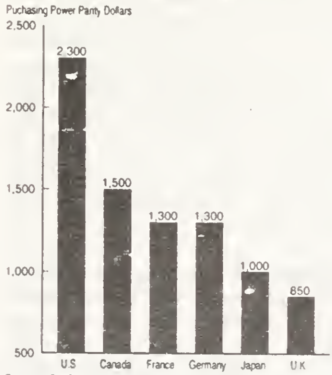
Source Educational Testing Service

The cost of health care is a growing problem. U.S. health care expenditures per capita far exceed those of any other country. In 1991, expenditures in the United States were nearly $2,300 per person compared with about $1,500 in Canada, $1,300 in France and Germany, $1,000 in the Japan, and $850 in the United Kingdom. (See Figure 37.) Spending more for health care would not be as big a burden if it resulted in a considerably more healthy society. But such has not been the case. Infant mortality in the United States—at 8 deaths per 1,000 births—is higher than in France, Canada, and Japan and only on a par with West Germany and the United Kingdom. In addition, life expectancy for a U.S. citizen in 1990 was 76 years, compared with Germany at 75 years, the United Kingdom at 76 years, France and Canada at 77 years, and Japan at 79 years. Clearly, improvements in the delivery of health care could pay handsome dividends in terms of higher living standards.

Figure 37

Per Capita Health Care Expenditures in 1991

The U.S. Spends More Than Other Countries



Source: OECD

– 5 –
New Competitiveness Issues On The Horizon.

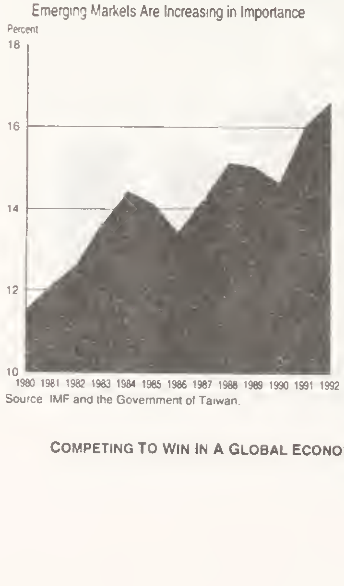
Big Emerging Markets. Given the speed with which the world is changing, we need to keep track of not only our traditional industrial competitors but also of an up–and–coming group of emerging nations that are becoming powerful players in the world economy in many sectors. Conservative estimates suggest that some 60 percent of the growth in world trade (excluding trade within the European Union) will be with developing countries over the next two decades. Of this growth, most will be in 10 markets: the Chinese Economic Area (including Hong Kong and Taiwan), Mexico, South Korea, Indonesia, Brazil, Argentina, India, South Africa, Turkey, and Poland. In fact, by the year 2010, these Big Emerging Markets (BEMs) are likely to double their share of world GDP.

Besides providing fertile market opportunities, these nations must be considered emerging competitors, as can be seen from

Figure 38

BEMs' Share of World Exports

Emerging Markets Are Increasing in Importance



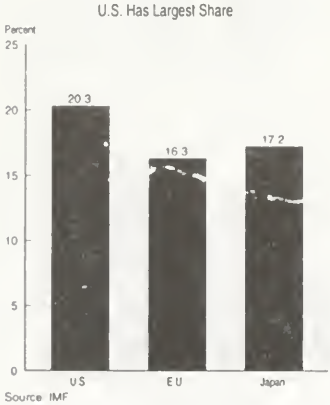
Source: IMF and the Government of Taiwan.

their shares of world exports, shown in Figure 38. Currently, the United States has a large share of the Big Emerging Markets' imports. (See Figure 39.) However, much of our edge is due to our large share in Latin America. Vigorous efforts are necessary in other parts of the world, particularly Asia, where Japan heavily out-invests the United States. (See Figure 40.)

Adaptable Workforces: Prerequisites of Competitiveness. As shown earlier in this report, one of the strengths of the American economy is its ability to create jobs. But many of these jobs are in low-value added areas in which pay is relatively low. Indeed, the primary structural labor market problem in the G-7 is a shift in relative labor demand *away from* less educated workers and those who perform routine tasks and *toward* workers with problem solving skills.

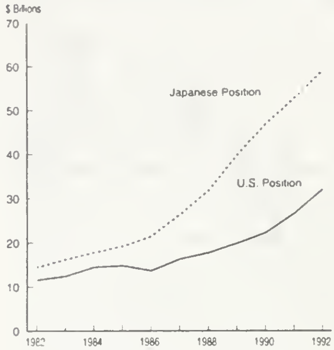
The challenge is to find a means to create these high-wage jobs. The G-7 Jobs Conference held in Detroit this past spring concluded that "experiences strongly suggest that a new approach to employment is needed—one that invests in the skills of all workers so that they can participate in economic change."

Figure 39
Shares of Big Emerging Market Imports, 1992
U.S. Has Largest Share



Source IMF

Figure 40
U.S. & Japanese Direct Investment in East Asia
Japan Invests Far More



Sources U S Dept of Commerce,
Japanese Ministry of Finance

Information Technologies Industries and Jobs. The U.S. information technologies sector is highly innovative, a major contributor to the nation's gross domestic product, and a leading exporter. The sector has great potential for employment growth, especially in such occupations as software programming, systems design and integration, and the creation of information services. Recent projections by the Bureau of Labor Statistics indicate that as many as 1.9 million new jobs for computer programmers, systems analysts, engineers, and data processing personnel could be generated by 2005.

"Next Generation" Trade Issues: Environment, Labor Standards, Competition Policies, Technology Policy. In the past, the differing domestic economic and social policies of countries were considered to have only a minor effect on international commerce. However, in the light of falling formal trade barriers and economic glob-

alization, such policies are now perceived as having an impact on trade.

For example, in the environmental arena, differences in levels of environmental protection and lack of agreement on environmental standards are under intense discussion in many trade forums.

As many countries with low labor costs and much lower living standards are industrializing and exporting, concerns over labor standards and fair treatment of workers have arisen.

With many industries becoming globally integrated, differences in antitrust policies, as well as other domestic economic and social policies, may lead to distortions in trade and investment flows.

Finally, the emerging agenda for issues related to competitiveness will include the rules for trade in high technology industries, including the role that governments should—and should not—play.

– 6 –
Recommendations.

The administration believes that we must forge a stronger partnership between the public and private sectors. The need now is for the Congress and the administration to work together to implement policies that will create the tools that the private sector needs for doing its work of economic expansion. Efforts in the following areas are particularly vital to the United States' international economic competitiveness.

Continue budget deficit-reduction efforts. Promoting savings in order to expand investment is critical to securing non-inflationary growth. The President's budget last year and the final Omnibus Budget Reconciliation Act of 1993 did precisely that. We must continue to hold firm on the path of deficit reduction as established by the President and agreed to by the Congress.

Continue to press for trade liberalization. Expanding trade is an important way to make our economy more productive. The administration has already accomplished much by the creation of the National Export Strategy, securing the passage of the North American Free Trade Agreement (NAFTA) and reaching agreement on the Uruguay Round of the General Agreement on Tariffs and Trade.

Our most urgent recommendation in this area is the passage of the legislation approving the Uruguay Round Agreement.

A successful conclusion to the U.S.–Japan Framework Negotiations will also help many of our key industries expand their access to a vital market. In Japan and elsewhere, negotiations should be pursued to expand our access to foreign markets, protect our intellectual property rights, and guard against unfair trade practices

Continue to strengthen the technology base. Enhancing our technology base depends on creating tools for the private sector. The administration is increasing the research and development budget and refocusing it on civilian areas, promoting the commercialization of technology, and helping U.S. firms adopt newer, more efficient manufacturing methods. We must work closely with industry in order to understand their needs, assess ongoing programs, and chart a new strategy for government-industry cooperation.

We must also recognize that technology policy is a critical element of economic policy. An important first step is the accurate assessment of the health and competitiveness of the manufacturing infrastructure and the identification of deficiencies that

require the attention of industry and government. Part of that process is undertaking a more complete analysis of what our competitors are doing. We must redouble our efforts to build a 21st century technology infrastructure to accommodate both the information highways that move thoughts and ideas and the transportation highways that move goods and people.

Continue efforts on human resource development. Our citizens are our greatest competitive asset as well as the object of our competitiveness policies. We must implement the administration's initiatives to make our workforce as capable as it can be and enhance its ability to face the winds of global change. Doing so requires enacting national health care reform, welfare reform and the President's reemployment proposal. We must continue implementation of initiatives on education and worker retraining.

Continue vigorous export promotion. The Trade Promotion Coordinating Committee must continue to implement vigorously the National Export Strategy, with a particularly strong focus on the Big Emerging Markets. In our report to Congress next month, we will detail efforts to implement the strategy as well as recommend additional strategies for the future.

Continue to implement the National Performance Review. The government must serve as an example of increased productivity by making changes necessary to improve our efficiency. While much has been accomplished, much remains to be done in implementing recommendations generated by the National Performance Review, which is an ongoing process of self-examination and change. Changing traditional ways of doing things and abandoning systems and procedures that have been place for many years is never easy, but government must be a leader in modernizing its structure and practices.

Promote sustainable development. The Department of Commerce must continue to be a leader in protecting the environment, creating high-quality jobs, and ensuring that the benefits of a cleaner environment and increased economic opportunity are available to all Americans. The government must promote both economic growth and environmental protection in a socially just manner. New technologies for products, greater efficiency, and better decisionmaking are key components of economic growth. They are also essential in our efforts to reduce and eliminate harmful environmental effects and manage the ecosystem's sustainability.

DEPARTMENT OF COMMERCE COMPETITIVENESS AGENDA

In the coming year, the Department of Commerce will be active in many of these areas. The Department's programs and policies are spelled out in more detail in Part II. However, the specific competitiveness agenda for the Department of Commerce, working with other parts of the Administration, will include:

THE NATIONAL EXPORT STRATEGY: Exports = Jobs

- The passage and implementation of legislation approving the GATT Uruguay Round.
- Fulfillment of the fiscal year 1994 National Export Strategy action plan and reporting to Congress on future plans.
- Implementation of NAFTA.
- The successful conclusion of the U.S.–Japan Framework Negotiations.
- Reducing barriers for trade through continued review of the export control system.
- Vigorous enforcement of our trade laws.

CIVILIAN TECHNOLOGY: Foundation for Growth and Competitiveness

- Passage and implementation of the National Competitiveness Act, which will give the Department of Commerce new resources to promote the development, diffusion, and application of advanced manufacturing technologies and to monitor and assess foreign technology capabilities relative to those of the United States.
- Full implementation of the National Information Infrastructure Initiative and integration with the Global Information Infrastructure Initiative.
- Industry benchmarking to help determine, in partnership with business and industry representatives, the existing state of knowledge about the competitive position of strategic U.S. industries and sectors relative to our main trading partners.
- Full implementation of the Administration's Defense Conversion and Dual-Use Technology Program.

ECONOMIC DEVELOPMENT: Creating Competitive Communities

- Introduction and pursuit of an initiative to link economically distressed areas to the benefits obtained from enhanced economic competitiveness.
- Legislative authorization, for the first time, of the Department's Minority Business Development Administration.

SUSTAINABLE DEVELOPMENT: Economic Growth That Respects the Environment

- Implementation of the Department's Environmental Technologies Exports initiatives.

Department of Commerce Efforts To Improve U.S. Competitiveness And Raise U.S. Living Standards

Part II ■ Department of Commerce Efforts to Improve U.S. Competitiveness and Raise U.S. Living Standards

The Department of Commerce is unique in that its central focus is competitiveness. Its efforts are organized into five broad but interconnected strategies: Civilian Technology, Trade, Economic Development, Sustainable Development, and Tracking U.S. Economic Performance. Close work with the private sector is a key element of all five strategies.

CIVILIAN TECHNOLOGY

Technological innovation and commercialization is of increasing importance in the new knowledge-based global economy. Rapid and continuous improvements in products, and the techniques to manufacture and bring them to market more efficiently, are now what give businesses—and nations—the competitive edge. In this environment, the high-technology sector is critical to economic prosperity. Average annual compensation in the high technology sector, for example, exceeds by 20 percent the average for all manufacturing. High technology products also account for a rapidly increasing share of the manufacturing output of industrial countries—35 percent in 1992, nearly double the 1980 figure. By any measure, maintaining our competitiveness in technology development, deployment, and use is essential to our nation's economic future.

Strengthening Civilian Technologies.

Almost immediately upon taking office, the administration made clear its commitment to move toward a policy designed to support the development and commercialization of civilian technology. The administration's policies and programs assign the federal government a supporting role, performing as a partner to industry by facilitating technology development and application. This entails:

- Shifting federal R&D resources towards a 50/50 balance between military and commercial spending.
- Launching the Technology Reinvestment Project and expanding the Advanced Technology Program.
- Creating the National Information Infrastructure (NII) and Global Information Infrastructure (GII) initiatives.
- Establishing a national network of manufacturing extension centers.
- Extending the R&D tax credit.

The Department of Commerce's Four Part Program.

The Department of Commerce has established a four part program to enhance the technological capabilities of American industry. These programs are based on the recognition of the primacy of civilian technology to economic growth, and on the role of industry as the primary creator of new technology and the main engine of sustained economic growth,

The development of high-risk, advanced technologies.

- The Commerce Department's Advanced Technology Program (ATP) has been dramatically increased. Designed to spur industry's development of high-risk, high payoff commercial technologies the ATP has been expanded from a pilot program in 1992 to a $431 million national program for fiscal year 1995.
- The Department has continued to emphasize manufacturing by increasing funding of its Advanced Manufacturing Research Programs and other research efforts at the National Institute of Standards and Technology (NIST), and its support for environmental technologies at both NIST and the National Oceanographic and Atmospheric Administration (NOAA).

Facilitating the deployment, diffusion, commercialization, and use of technologies. Department initiatives include:

- The NIST-managed Manufacturing Extension Partnership has established a nationwide network of manufacturing extension centers to assist small- and medium-sized businesses to modernize and become more competitive.
- The Department's Office of Air and Space Commercialization has promoted the trade of space-related goods and services, while numerous Cooperative Research and Development Agreements (CRADAs) and other cooperative partnerships with private and public sector organizations have promoted research, development, deployment, and use of technologies that increase the competitive position of U.S. companies in the global economy.

Working closely with industry. The Department of Commerce has acted as a voice for our businesses and industry "customers" in government-wide technology efforts, including the National Science and Technology Council. In addition, the Department's Technology Administration has taken a number of steps to work more closely with industry:

- Facilitating the creation of public-private partnerships, including the Partnership for a New Generation of Vehicles.

- Promoting the development of industry "Road Maps" which provide a forum for industry to set its goals, discuss barriers to competition, and design appropriate government and industry actions.
- Developing "Benchmarks" which capture the relative strengths and weaknesses of several strategic industries and sectors of the economy.

Creating a 21st Century Information Infrastructure. The administration has launched an ambitious effort to stimulate the development and deployment of an advanced National Information Infrastructure (NII). This effort is guided by five principles: encouraging private investment, promoting competition, creating a flexible regulatory framework, providing open access, and ensuring Universal Service. Under the leadership of Vice President Gore and through the interagency Information Infrastructure Task Force chaired by Secretary Brown, the administration is working closely with business, labor, academia, and public interest groups as well as Congress, and state and local governments. The Department of Commerce has taken a number of steps to aid our efforts, these include:

- Establishing the private sector National Information Infrastructure Advisory Council.
- Holding hearings on Universal Service, Privacy and Security, Intellectual Property Rights, R&D, standards and other issues;
- Releasing for public comment a number of draft reports and papers including "A Vision for Government Information Technology Services and the NII" and "Putting the Information Infrastructure to Work";
- Initiating an ambitious grants program, administered by the Department of Commerce's National Telecommunications and Information Administration, to provide $26 million this year and more than $60 million next year in matching funds to state and local governments, school districts, health care providers, and other non-profit entities for NII pilot and demonstration projects.

Information is important to the global economy. To develop a broader understanding of the policy issues associated with the development and implementation of the Global Information Infrastructure, the Commerce Department has held a series of public hearings. To help stimulate international dialogue and facilitate international negotiations, the Department is developing a set of guiding principles that will be published as the "GII: Agenda for Cooperation."

TRADE

A key component of enhanced competitiveness for U.S. firms and workers is the maintenance of an open trading system. The Department's efforts are directed to three strategies: market opening initiatives, enforcement of trade laws, and export promotion.

Market Access Initiatives. The Commerce Department has worked vigorously with other agencies of the federal government to achieve greater access for U.S. exporters.

- ***The Uruguay Round.*** The Uruguay Round will create enormous potential for world trade and economic growth through tariff reductions, extension of GATT rules to intellectual property, services and trade related investment measures, and improvements in trade rules. Securing passage of legislation implementing the round is critical to 21st century competitiveness.
- ***Regional Initiatives.*** The Department is an important participant in numerous initiatives, including:
    - *NAFTA implementation*, to ensure American business takes advantage of the opportunities created by this agreement;
    - Negotiations and trade promotion efforts in *Japan,* to open this historically closed market;
    - Ongoing efforts in *Europe,* to ensure that the creation of a broader European free trade area does not disadvantage the United States;
    - Ongoing efforts in the Asia–Pacific region, centerd on APEC (Asia–Pacific Economic Cooperation), to ensure that regional initiatives advance free trade in the region and globally.
    - Identification of key countries with maximum opportunities for the growth in U.S. exports—the *Big Emerging Markets,* particularly in Asia and Latin America—as a new focus for our commercial policy efforts, and
    - Efforts to assist the *Economies in Transition*—from Russia and the Newly Independent States to the Middle East—to meet the challenges of democratization through enhanced participation in the global market economy.

Trade Law Enforcement. Unfair foreign pricing practices and government subsidies distort the free flow of goods, adversely affect U.S. business, and reduce the ability of U.S. firms to compete in the global marketplace. The antidumping and countervailing duty laws, administered by the Commerce Department, provide remedies to these unfair trade practices. The Uruguay Round negotiations produced a number of improvements to these laws. The De-

partment is committed to the vigorous enforcement of the laws and implementation of the changes negotiated in the Uruguay Round.

Building a National Export Strategy. The Trade Promotion Coordinating Committee (TPCC), an interagency task force of 19 agencies chaired by Secretary Brown, is an effective forum for dramatically improving federal cooperation and launching new interagency trade promotion initiatives. In October 1994, the TPCC will issue its second annual report to Congress detailing implementation status of the National Export Strategy. Highlights of progress to date include:

- *Advocacy.* We have established an interagency network with an Advocacy Center at the Department of Commerce as the central contact point and clearinghouse for information and action on major projects of benefit to American firms. Many successes have already been registered.
- *Export Finance.* The TPCC is implementing a more flexible and aggressive approach to trade finance, including: creating a $150 million Capital Projects Tied Aid Fund, establishing a new outreach office at Commerce on multilateral development bank procurement opportunities, and raising the Overseas Private Investment Corporation's project limit to $200 million under each of its insurance and guaranty programs.
- *Export Controls.* Consistent with national security objectives, the Clinton Administration has liberalized controls on computers and telecommunications exports, streamlined the export controls process, and is seeking new legislation to establish a regime of export controls for the post–Cold War world.
- *U.S. Export Assistance Centers.* Pilot interagency one-stop shops are now open in Baltimore, Chicago, Miami, and Long Beach (Calif.). Eleven additional centers are slated to open in 1995.

ECONOMIC DEVELOPMENT

An important responsibility of the Department of Commerce is to provide assistance to those communities and businesses bypassed by the process of economic change or that have suffered economic dislocation as a result of economic change. Such efforts strengthen the nation's competitiveness by helping all segments of our economy to grow and prosper. Key elements include:

Regional Development. Secretary Brown recently announced the Competitive Communities program, an aggressive plan by the Economic Development Administration (EDA) designed to support local efforts to build, support, and attract competitive businesses in urban and rural communities. EDA also

provides support for local development through such activities as public works, technical assistance, trade adjustment assistance, and university centers.

Minority Business Development. Through the provision of management and technical assistance, the Minority Business Development Agency seeks to bolster the competitiveness of minority businesses.

SUSTAINABLE DEVELOPMENT: ECONOMIC GROWTH AND ENVIRONMENTAL GOALS

The Clinton–Gore Administration is integrating economic development and environmental stewardship, while working for environmental justice, for the present and future benefit of all Americans. This is the essence of the evolving concept of sustainable development—defined as development that meets the needs of the present without compromising the ability of future generations to meet their own needs.

With its responsibilities to promote economic growth, expand international trade, advance civilian technology, foster community development, protect natural resources, and monitor the environment, the Department has an important role in simultaneously stimulating economic growth and advancing environmental stewardship. In doing this, the Department works with other federal agencies, including the Departments of Energy and Interior and the Environmental Protection Agency, and with partners outside the executive branch, to advance the shared goals of sustainable development. Recognizing this, Secretary Brown is the first Commerce Secretary to place the mission of the Commerce Department—to ensure and enhance economic opportunity for all Americans—within the context of sustainable development.

The Department promotes sustainable development in many ways.

- First, by creating the opportunities and incentives for businesses, communities, and individuals to prosper through environmentally sound growth. This includes:
    - supporting and promoting U.S. exports of environmental technologies to rapidly growing world markets;
    - participating in industry-government partnerships in key sectors, such as autos, to simultaneously reduce environmental impacts while increasing competitiveness; and
    - integrating economic-environmental data for national accounts as an important step towards improved information for decision-makers.

- Second, by improving environmental monitoring, prediction, and assessment through:
    - predicting changes and trends in weather and climate, and the risks they create; and
    - developing the knowledge required for integrated ecosystem management—so that economic growth can proceed in a sustainable manner.
- Third, by encouraging the development and diffusion of eco-efficient technologies. Such technologies enable companies to use natural resources more efficiently and to minimize the costs associated with pollution, thereby improving their competitiveness and profitability. The Commerce Department advances the development and use of eco-efficient technologies, through:
    - laboratory-based research,
    - support for industry research and development, and
    - diffusion of environmentally sound state-of-the-art technologies.

TRACKING U.S. ECONOMIC PERFORMANCE

Both business and government depend upon critical data to plan and implement efforts to become more competitive. The Department's Economics and Statistics Administration is striving to provide more relevant economic and social data that describe and measure U.S. economic progress and our standard of living.

U.S. COMPETITIVENESS AND TRADE POLICY IN THE GLOBAL ECONOMY

WEDNESDAY, SEPTEMBER 28, 1994

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:06 a.m., in room SD–538 of the Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN DONALD W. RIEGLE, JR.

The CHAIRMAN. The Committee will come to order. Let me welcome all those in attendance this morning.

As we often find in the homestretch of a session of Congress like this, virtually every Committee is meeting at once, including the Finance Committee, where I serve as a Member myself. It's meeting at this time and so I know we'll have a problem with Members coming and going as best they can with other requirements, including activity on the Senate Floor.

I want to welcome our witnesses this morning. This is a most distinguished panel.

Our purpose today is to assess the situation in the United States and world capital markets and, as best we can, to try to take a look at where we are, where we are going, and what the issues are that we need to understand better in terms of what the future will look like and what responsible choices in policy may face us in looking at that picture. Obviously, that takes place within the context of an integrated world capital market.

We all know that the capital markets play an absolutely crucial role in our own national economy. American businesses rely on the capital markets to finance their operations and for expansion.

Large, established companies, for example, now regularly access the capital markets directly by using commercial paper and have done so now for a long time and that, of course, has reduced their dependence upon commercial banks. Younger companies often raise capital through initial public offerings of stock, or IPO's, as they're called.

In the course of today's hearings, we'll assess the strength of our capital markets and how well they're performing their function of providing investment opportunities for investors and vitally needed investment capital for worthy users.

Review of the U.S. securities market will not complete this inquiry, however. We can no longer consider our capital markets without also considering the global capital markets.

As Felix Rohatyn, who we will hear from this morning, stated in a recent article, and I quote:

A genuine worldwide market in stocks, bonds, currencies, and other financial instruments has emerged, tied together by modern data-processing and communications technology and operating 24-hours-a-day, 7-days-a-week.

I think it's well for us to consider the challenges posed by the integration of the world capital markets and how we should respond to those challenges.

With regard to our markets, the SEC's Market 2000 report released earlier this year found, "Our system is working well to raise capital and provide a wide range of investment opportunities for an ever wider range of investors."

One important indicator is the volume of initial public offerings. IPO's have proceeded on a strong pace in recent years. 1993's record $57 billion in IPO's easily topped 1992's $40 billion, which also was a record. Another sign of strength in the securities markets is that individuals are increasing their participation as well. Often disappointed with what in the recent period have been low yields on insured deposits, individual investors have been putting their money into mutual funds in record amounts. Mutual funds now own roughly 10 percent of all U.S. stocks, up from under 3 percent in 1980.

This growth in mutual funds has contributed to growth in securities trading. For example, average daily trading volume on the New York Stock Exchange hit a record 264 million shares in 1993, up from 202 million shares the year before. Spurred by these record securities issues and strong trading, Wall Street has posted record profits as well in recent years.

While our securities markets appear healthy, a number of important challenges are nevertheless before us. A prime example is the growth of the market for derivative financial instruments.

According to the GAO, the notional amount of derivatives more than doubled from 1989 to 1992. This growth has occurred because derivatives allow customers to manage the financial risks associated with their operations more efficiently. Most derivatives involve hedges against changes in foreign exchange rates, interest rates, commodity values or equity values.

But as we've seen, derivatives themselves are not without risk. In recent months, there have been numerous losses stemming from derivatives at a variety of firms in mutual funds, including Procter & Gamble and Bank of America's Pacific Horizon Money Market Fund.

And then, just yesterday, Community Bankers Mutual Fund, a small money market fund, announced it was liquidating as a result of investments in "structured notes," and in this case, structured notes issued by U.S. Government agencies.

To my knowledge, that's the first instance where we've had a mutual fund have to dissolve itself because of losses sustained by trading in derivative instruments.

In a recent study, the GAO recommended that Congress require regulation of derivatives dealers that are presently unregulated, affiliates of securities firms and insurance companies. I've introduced legislation to accomplish that objective.

The SEC and the bank regulators have argued that they already possess adequate authority to regulate derivatives and I expect that we'll continue that debate here this morning.

The growth of the mutual fund sector poses another challenge. SEC resources have not kept up with the explosion in mutual funds. SEC Chairman Levitt, who is here and will testify first this morning, has said previously that that problem of matching resources to expanded volume of activity, in his words, "constitutes a serious shortfall in the Commission's resources."

In addition, the regulatory structure that governs the industry has scarcely changed in 50 years. In part, this is because the SEC has broad authority to address new situations by issuing exemptions. Changes in the law may be needed to keep up with changes in the market, however.

A 1992 SEC study recommended changes in areas including how mutual funds may advertise to investors, the rights of mutual fund shareholders, how shareholders may redeem their shares, and the disclosure provided to pension fund participants.

As I said earlier, I think it's clear that we have to be concerned with more than just our own domestic markets. To demonstrate the extent to which world capital markets are becoming integrated, consider that more than 500 foreign companies from 35 foreign countries are now traded on U.S. stock exchanges. Cross-border stock purchases reached a record $159 billion in 1993. U.S. investors accounted for 42 percent of that figure, purchasing an estimated $66 billion in foreign stocks. U.S. mutual funds and pension funds have become significant purchasers of foreign equities.

The internationalization of the capital markets, I think, poses a number of challenges for us to consider. The risk that a disruption in one financial sector would be transmitted throughout the financial system is increased as a result of the increasing linkages between world markets. The development of foreign markets also means that United States securities and futures exchanges face greater competition, not just from London and Tokyo, but from Shanghai, Singapore, and elsewhere. I think we'll hear about that this morning.

United States stocks are often traded offshore, in some cases, to avoid reporting requirements. This underscores the need for greater cooperation among securities and futures regulators around the world.

Some critics warn that U.S. regulation could drive activities offshore without protecting investors. I think we have to ensure that competition among world exchanges does not become a race to the bottom, leaving investor protections behind. I think it's fair to say that our witnesses this morning are truly superbly qualified to discuss these issues.

First, we'll be hearing from SEC Chairman Arthur Levitt. I would say that the Chairman at the SEC has done a superb job since taking over that responsibility. He's refocused the agency on the concerns of smaller investors, strengthened the SEC's consumer affairs office, and formed a consumer advisory committee.

He's given a great deal of attention to improving the sales practices of retail brokers. He's also promoted self-funding for the agency, a concept that I initiated when I Chaired the Securities Sub-

committee some years ago and one that I continue to strongly support.

Self-funding would allow the SEC greater certainty regarding its resources so they could better carry out the mission of protecting individual investors that is so important to Chairman Levitt and to all of us who follow these issues.

He will be followed by three of our country's leading financial experts, and I very much appreciate them all making the time to come and be here with us this morning.

Gerald Corrigan, currently an advisor to Goldman Sachs & Company, and formerly president of the Federal Reserve Bank of New York, is well known to this Committee and an old friend of this Committee and has appeared here any number of times at key points when his participation was needed.

Felix Rohatyn of Lazard Freres & Company, and the former head of New York's Municipal Assistance Corporation, is also well known to us. In fact, it was this Committee that had the responsibility for the legislative production of the New York City loan guarantees, among other things. So, that relationship goes back a good many years.

Then, finally, Mr. Leo Melamed, another friend of this Committee who has been here before and has been very helpful to us over the years as we've had to work through some of these important market issues and some of the problems that have arisen, and who served importantly as the former chairman of the Chicago Mercantile Exchange.

And so, with this line-up of all-star witnesses today, I think we can probably look at these issues in as full a scope as we could hope to do so.

Before turning next to Senator Domenici for comments that he has and the other colleagues that are here, I want to pay a tribute to the Chairman of the Securities Subcommittee, Senator Chris Dodd.

He's done an outstanding and productive job of leading the Securities Subcommittee during the past 4 years. I'll say more when he's present. But it's very important that his work and leadership in that area be spotlighted as we get into this discussion today of where we're going in the areas that I've laid out here.

Senator Domenici.

Senator DOMENICI. Mr. Chairman, why don't I yield to Senator Faircloth.

Senator FAIRCLOTH. No, go ahead, Senator.

Senator DOMENICI. I was thinking about what I want to tell Felix.

The CHAIRMAN. All right. Senator Faircloth.

Senator DOMENICI. About New York's current condition.

Senator FAIRCLOTH. There isn't any way I'll be your senior.

Senator DOMENICI. Well, you're older than I am, so——

OPENING STATEMENT OF SENATOR LAUCH FAIRCLOTH

Senator FAIRCLOTH. That I am, older than everybody.

[Laughter.]

Good morning, Mr. Levitt. Delighted to see you. I want to welcome you here and I feel a special closeness to you because of what

you have done for the Banking Committee and the relationship you have developed with it. And I thank you for being here.

As you know, I have spent all of my life in the private sector in a number of businesses—farming, automobile, construction, and others, and even helped start a couple of small banks. So I'm very sensitive to the need for capital. We all know, having been in business, that capital is the lifeblood of any business and if you don't have access to it, you simply cannot function.

Today, businesses in America, both small and large, are competing in the world market for capital. And you cannot separate the American, U.S. capital market, from the global capital markets.

Congress and the regulatory agencies need to find new ways to allow small businesses to access the capital markets without all the legal costs and paperwork burdens. We need to lower the expense and complications that large businesses face when going into the U.S. capital markets for money. If we don't, either our foreign competitors will or capital will flow elsewhere. Either way, American workers and businesses are going to be the losers.

I again thank you for being here and look forward to the questions.

The CHAIRMAN. Thank you very much, Senator Faircloth.

Senator Shelby.

OPENING COMMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Mr. Chairman, I have a written statement I'd like to be made part of the record where we can get into the testimony.

The CHAIRMAN. Very good. Without objection, Senator Shelby's statement will be made a part of the record.

Senator Domenici.

OPENING STATEMENT OF SENATOR PETE V. DOMENICI

Senator DOMENICI. Mr. Chairman, I might not have a chance of appearing—I think you have one final hearing on the confirmation of the nominees. But the 103rd Congress is going to end shortly and I think I'd be remiss if I didn't take a couple of minutes to say a few words about your leadership of this Committee.

Are you going to overrule me on that, or what?

[Laughter.]

The CHAIRMAN. Well, I won't overrule my friend.

Senator DOMENICI. Let me say that much has been accomplished on your watch. We have overhauled the banking industry. We have revised regulations and established new safeguards protecting banking consumers and we've reauthorized Federal housing programs. While the latter will be an ever-evolving drain on any Committee, I think we've made some headway on housing, as tough as it is.

We most recently held hearings on the first phase of the so-called Whitewater Matter and obviously, I'm a Johnnie-come-lately and I join a chorus of Senators complimenting you on the work you did there. I think you were eminently fair and thorough.

I think you've led this Committee extremely well and for those of us who are going to continue to serve in the 104th, let me say

that your effective leadership is going to be missed. I'm going to miss your friendship, in addition to your leadership.

You have had input in many other ways besides on this Committee. Obviously, I know much about that as it pertains to the budget and the budget process. I know you care and care deeply about the people you represent and you're constantly seeking ways to make a better life for more people.

I am going to miss the contributions that you make around here and the counsel that you provide just by being the Senator that you are. So I want to make sure that this record, which may be the second-to-last under your Chairmanship, includes my few brief remarks about you.

I thank you for giving me that time.

The CHAIRMAN. I thank you very much for those personal comments.

We've spent a long time together here and I had the chance and had the good fortune to serve with you on the Budget Committee and during your time as Chairman of that Committee. I learned a lot there. In fact, I've actually tried to apply some of those lessons here on this Committee.

But I appreciate the bipartisan nature of the way we've been able to work on this Committee. I think that's the key to making our whole system work. There are always going to be differences of opinion, but I think figuring out a way to work through them as best we can in a spirit of goodwill and accommodation is what holds this Country together at the end of the day.

I'll miss the Senator from New Mexico and I'm touched and very appreciative of his personal remarks.

Senator DOMENICI. Mr. Chairman, I had some detailed remarks on the significance to the American economy and our daily lives of the financial services industry. I was going to allude to 15 or 20 obvious cases of discrimination against our financial service industry. I would like to put that in the record.

But I do want to comment that the time is coming when we're going to have free and open trade. Sooner or later, we're going to have to find a way to make sure that other nations give our financial institutions and our financial capabilities to institutions, many institutions, not only banking, the same kind of consideration as we give to them.

Obviously, it's not very much in the interest of foreign countries because our markets are so open, to do anything for our institutions with their financial industries.

We do have grave discrimination, from insurance to banking and everything in between.

I'm very hopeful that we're going to make some strides in that regard as we move through the GATT agreement. There are various proposals for continued dialog with these countries that are discriminating against us.

I'm not sure we're going to make the kind of headway that this industry deserves. Those countries that are discriminating ought to know that we would help their economy if they permitted the kind of competition for ideas, innovation, and excellence we allow, because no economy has the kind of contribution by its financial institutions as ours.

We give money to those who need it. It's finely tuned. It's absolutely competitive. Many countries don't understand that they would benefit greatly by injecting that into theirs and letting our people go there.

Chairman Levitt is here and I don't need to comment about the great job he's done. He knows how I feel about that.

I do think that we have some problems. Everything is great when all mutual funds are growing, when everybody is making money. But, they are not so great when they come down to the reality of losing money. Obviously, the banks are somewhat in the middle on this because they were losing all of their savings to mutual funds and so they wanted to get into that business. And the question is are we sure that they're doing right by those who purchase mutual funds? I think we'll be hearing about that here today from Chairman Levitt.

I've now been on this Committee for 4 years and one of the true delights of being a Senator is how much you get to learn.

I have a new and invigorated feeling about America's financial institutions and the capital markets. Obviously, we have to watch out because there is lots of money to be made there. We're a country of great entrepreneurs and plenty of people who will go the limit to make money. But I think this is a credit to the competitive capitalistic economy, economic principles, and I have learned to respect it greatly.

If you would put my statement in the record in toto, Mr. Chairman.

The CHAIRMAN. Without objection, Senator Domenici's statement in toto will be made part of the record.

Senator DOMENICI. Thank you, Mr. Chairman.

The CHAIRMAN. Senator D'Amato.

OPENING STATEMENT OF SENATOR ALFONSE M. D'AMATO

Senator D'AMATO. Thank you very much, Mr. Chairman. Chairman Levitt, it's good to see you.

Mr. Chairman, let me say I join in welcoming today's panel of distinguished witnesses. But before we turn to the subject of today's hearings, I'd like to commend you and take the opportunity to congratulate you for your leadership of this Committee over the last 6 years.

During last week's hearing, my colleague from North Carolina thought that you might feel like a pancake from all the syrup poured over you recently.

[Laughter.]

But I'm not here to butter you up today with false praise, but to say let's take a look at the record.

The truth is, Mr. Chairman, that your leadership has been anything but flat. With your able guidance, the Committee has risen to the serious challenges posed to the financial services system. The Committee has responded repeatedly and decisively to the crises in our thrift and banking industry, by developing and passing FIRREA under your leadership, FDICIA in 1991, and again under your leadership, the Committee has also made banks more competitive globally by finally breaking down barriers to banking

across State lines with the recently passed Interstate Banking and Branching Act.

Let me thank you again for that kind of leadership that makes possible a true competitiveness in a capital system that tries to keep a real balance.

You helped make the promise of economic development a reality through the passage of the Community Development Financial Institutions Bill, and that took a lot of work and a lot of genuine compromise. And in this bill, you also helped expand financing opportunities for small businesses by helping pass the Small Business Loan Securitization Bill.

I think that has tremendous opportunities because today, it is still difficult for the small borrower to get business loans and business financing. By allowing securitization to be able to come in, we may open up the doors and provide financing that heretofore has not been available. It is not and we understanding the various reasons.

I'm not damning the banks or condemning them, but this may make it easier for them to make capital available to the small businesses. And on and on it goes.

In 1990, this Committee again under your leadership passed legislation giving the SEC additional authority to impose discipline on the markets with the Market Reform Act and the Pennystock Reform Act in 1992. The Government opened up the Government securities markets by enhancing disclosure and increasing the transparency of this critical market.

Of course, you've helped pass these bills from the Members of this Committee, including the Chairman and Ranking Members. There have been lots of people helping. But it was your leadership skills, as well as your role as a mediator, and I can attest to this. Were it not for the Senator's role as a mediator, very little of this legislation would have passed.

So, Mr. Chairman, let me thank you for your years of stewardship. Let me commend you and assure you that it's a better feeling to maybe feel like a pancake with some syrup and butter than a hotcake.

[Laughter.]

I commend you for your leadership and your insight. I thank you and I wish you and your family a happy and prosperous future, and tell you that, as one Senator, I will miss your leadership, your camaraderie, and your sense of fairness that you've displayed to all of the Members of this Committee.

The CHAIRMAN. Thank you very much. I appreciate that.

Well, now being thoroughly covered with syrup here——

[Laughter.]

Chairman Levitt, you've heard the sentiments of the Committee Members that have spoken this morning about your stewardship over at the SEC.

We'll make your full statement a part of the record and we'd like your comments now.

STATEMENT OF ARTHUR LEVITT, CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, DC

Mr. LEVITT. Thank you very much.

I'm honored also to be here in one of the last sessions of your tenure and to say to you that I think you've represented the interests of American investors fiercely, ably, and comprehensively. The working relationship with this Committee has been a very constructive one as far as the Commission is concerned. I'm really honored to be part of this extraordinary process.

Before I address international issues, I should say a few words about an event that took place right here at home earlier this week which I know is being thought about by Members of the Committee.

Late Monday, the Community Bankers U.S. Government Money Market Fund, a small institutional money market mutual fund, advised the Commission that it was going to liquidate. That is, it's going to redeem the shares for less than a dollar.

The fund has so notified its shareholders in writing and, with one exception, all of the shareholders are institutional. They are all banks or bank-holding companies. The fund has no individual shareholders and no public money is involved in this.

I assure you that the Commission is actively monitoring the situation and will keep the Committee apprised of developments. While any money market fund breaking a dollar is obviously a matter of concern to us, we don't believe that its effects on the capital market should be overstated. It should, however, serve as a reminder to investors that a money market fund is not insured, is not guaranteed.

As I stated before this Committee on several occasions, safeguarding the interests of American investors is my foremost concern at the Commission. Indeed, the international issues facing the Commission have much to do with the safety and integrity of our markets.

To maintain the competitive position of U.S. securities markets internationally, the Commission must maintain the confidence of individual investors in these markets. At the same time, American investors today are less willing than ever to restrict their interest to American issues alone.

To serve these investors, the Commission is working to internationalize American markets by attracting foreign issuers. In recent years, dramatic political and economic changes in the world have been accompanied by dramatic changes in global financial markets. Securities markets in the United States and throughout the world have grown. Through all this growth and change, however, American capital markets have remained pre-eminent. Our capital markets are recognized as the most liquid, innovative, efficient, and fair in the world.

In an increasingly competitive international securities environment, maintaining this reputation is a crucial objective. I would say that in charting the course of where the Commission is going and what the priorities, my personal priorities, are, seeing to it that America does nothing to lose its competitive advantage in terms of being the pre-eminent international capital marketplace ranks high on that list.

A review of some statistics illustrates that our market's reputation is well deserved.

At the end of 1993, United States equity market capitalization was about $5.2 trillion, more than that of Japan, the UK, Germany, and France all combined.

Trading volume in our equity markets increased from $2.2 trillion in 1989 to about $4 trillion in 1993. During the same 5-year period, trading volume in Japan sharply declined, from surpassing that of the United States in 1989, to being only one-fifth our volume in 1993.

But a more important measure of a market's strength is its ability to raise capital and thus create jobs and support new industries. U.S. markets have succeeded spectacularly here, raising over $950 billion in capital through securities offerings in 1992. The following year, that figure broke a trillion. By way of comparison, in 1992, Japan raised only $75 billion through securities offerings.

Mr. Chairman, it's clear that individual investors are absolutely critical to the maintenance of strong U.S. markets. Over the last 5 years, individuals have accounted for about 49 percent of total U.S. equity holdings. In comparison, retail investors account for only 20 percent of overall equity ownership in the UK and only about 24 percent in Japan.

We expect to see more individual ownership in the United States during the years ahead, as Americans assume increasing responsibility for managing their own retirement assets.

In my 14 months as Chairman of the SEC, I have endeavored to sharpen the Commission's focus on the needs of individual investors. Let me illustrate how we've pursued that goal by discussing our recent initiatives in consumer affairs and broker integrity.

Consumer protection is a way of life at the SEC. In 1937, my distinguished predecessor, later Supreme Court Justice, William O. Douglas, interpreted the agency's mandate in this way. He said: "We've got broker's advocates. We've got exchange advocates. We've got investment banker advocates. And we are the investor's advocate."

Every year, our consumer affairs office receives more than 30,000 complaints, inquiries, and other communications from consumers. But that office hasn't always received the attention it deserves.

Its activities, for example, routinely came last in our annual report. We're now in the process of restructuring and strengthening that office. We've removed layers of bureaucracy so that it reports directly to the Chairman and we're providing it with new tools and resources to better handle the inquiries and problems of investors.

This year, we also created the SEC Consumer Affairs Advisory Committee, the first of its kind, to advise us on the issues facing the public in our markets. This Committee opens a channel through which the SEC can receive information to help us address the needs of investors. By formalizing the consultation process with this group, we expect to keep investor issues up front where they belong.

Mr. Chairman, our renewed emphasis on investor issues is only beginning. In the next few weeks, I'll be meeting personally with groups of investors around the country to hear their concerns and discuss the Commission's work. I'll also try to get out the word about some new investor services, such as our toll-free investor information line, our electronic bulletin board accessible through the

Internet, and the second brochure in our "Invest Wisely" series. This one describes mutual funds, the investment vehicle of choice for one out of four American families.

At the Commission, we've also been focusing intensely on sales practices and professional standards among brokers. A joint study we did with the exchanges in 1994 showed that only a small fraction of industry professionals were dishonest.

At the same time, we're working with the industry to produce an ongoing education plan for sales forces, to ensure that investors are getting the best, most up-to-date financial advice from their brokers.

As I suggested earlier, although these are domestic issues, they have international implications. Unethical brokers are a threat to the global pre-eminence of U.S. markets.

The Commission has been, and will continue to be, an active participant in global and regional organizations that study securities matters. Foreign companies are increasingly interested in having their securities traded or listed in the United States. The Commission is eager to work with foreign issuers to ease their transition into our regulatory system. I've already visited many countries to discuss the advantages of our markets.

Just last week, I returned to Germany with American financial analysts and German issuers to discuss the differences in our disclosure and accounting practices. In the past year, the Commission has acted to streamline the reporting and reconciliation requirements for foreign issuers.

I'm pleased to tell you that our efforts to attract foreign issuers have been successful. In contrast to the trend in other major public securities markets throughout the world, American markets are attracting a steadily increasing number of foreign companies. As of September 1994, there were a total of 637 foreign reporting companies representing 40 nations listed or quoted on our public markets.

Mr. Chairman, these measures will ensure that even as we internationalize our markets, those markets will remain the strongest in the world.

In the year ahead, the Commission will continue to explore ways to reduce costs for all issuers, foreign and domestic, large and small, who seek to raise capital in the U.S. market. We won't lose sight of one underlying reality—our markets are the deepest and most liquid in the world because of their transparency and their integrity.

As you know, this is the SEC's 60th anniversary year. Tomorrow evening, as we celebrate the many achievements of the Commission over its 60-year history, we will also remember your pivotal contribution to so many of these accomplishments.

Your support of the Commission during your 18 years in the Senate and your 10 years in the House have been extraordinarily helpful. In particular, your work on the Market Reform Act and the Remedies Act that Senator D'Amato mentioned has made a lasting difference in the work of the Commission.

I'm also very grateful for your recent assistance in connection with our budget crisis. Yesterday, the House approved legislation that will lead to a resolution. I hope that the Senate also will swift-

ly approve H.R. 5060, so that we can begin the fiscal year fully funded.

Mr. Chairman, all of us at the Commission salute you and the legacy you leave for this agency.

On behalf of the Commission and our entire staff, I offer you our best wishes for the years ahead.

Thank you very much.

The CHAIRMAN. Thank you for your statement and also for your very kind personal comments.

Let me ask you a question that I want to put to our other witnesses as they'll be coming behind you. I'd like you to highlight as best you can any potential problems that are looming out there on the horizon of the financial system, either domestically or internationally, that we really need to have up on the radar screen and to understand and monitor. What do you see there?

Mr. LEVITT. A career in the financial industry has taught me that the problems that you anticipate most carefully are usually the ones that don't occur. It's the total surprises that come back to bite you.

But if I were pressed to name the areas of greatest concern that I have, I would mention the flood of hundreds of thousands of new investors in the mutual fund field, investors who have taken money from certificates of deposit and savings bank deposits and purchased securities without really a total understanding of what they're buying, what risks may be involved.

Obviously, another concern is the development of a battery of new products, some called derivatives which have a dramatic impact on the market, again because of a lack of sophistication and a lack of understanding. The problem is not merely domestic, it's international, no matter how comprehensive our rules may be, or what kind of legislation may result to assist in that regard. The globalization of the marketplace and the international ramifications of the trading of these products represent, I believe, a potential systemic risk that must demand our attention.

I think that I spoke before about the importance of retaining our capital markets pre-eminence. I am concerned that the country focus on all of the elements that contribute to that. And that is not just a regulatory concern. It deals with taxes. It deals with legislative policy. It deals with whether this country continues to be hospitable to the interests of providing the kind of capital flows that are essential for us to compete in an environment which is more competitive today than ever before.

That competition for capital is being waged by economies all over the world. I believe that it's America's most important, most valuable economic resource. I think we're in a war and one that we must be relentless on all fronts of pursuing every possible avenue.

So those are the general areas of concern that I have.

The CHAIRMAN. As you watch the world change, and we've seen the collapse of the old Soviet Union and obviously, the efforts of all those economies to privatize and to get some lift and so forth, do you have a concern that, in light of that fortunate and positive development, we could at some point here see a problem where there isn't enough capital to go around, that there are so many capital investment needs and demands, that we could have a situation

where suddenly, we'd be on a growth curve that we couldn't handle just in terms of the competition for capital? Is that a matter that we ought to be thinking about?

Mr. LEVITT. I hope that that will not be the case. That relates to overall developments in the economy. It relates to the kind of burdens that we place on the American financial system.

I think that the beauty of the system thus far is that we have developed a sense of balance, that we've been mindful of protecting the public interest at the same time while not burdening the mechanism so enormously that it can't function well.

Up to now, we've moved in one direction, then in the other, but we've been pretty balanced. And I think the work of this Committee and your efforts in seeing to it that that balance doesn't get out of hand has been very constructive.

That is fundamental to our system. I think that this Committee and its predecessor Committees, for that matter, have maintained an objective, nonpartisan view of the importance of preserving America's position as the pre-eminent capital marketplace. And as long as that continues, I'm pretty sanguine about our ability to do the job.

The CHAIRMAN. In your testimony, you stress the need for development of international accounting and disclosure standards that would apply in all countries, and obviously, as it is now in this internationalized system, that becomes a more compelling question.

I would ask you, what steps have already been accomplished to harmonize these international accounting rules and what more needs to be done, either by the regulators, to the extent that that's where the effort should come from, or by the private sector itself?

Mr. LEVITT. Well, I think that what we have tried to do, in travelling around the world and meeting resistance from some countries with respect to allowing their companies to come list in the United States, the first thing they talk about are the difficulty in meeting U.S. accounting standards. A lot of this is cultural. A lot of this is a reluctance to embrace a standard merely because we call it an American standard.

I've tried to shift that debate by suggesting that we'd be perfectly comfortable with a standard that came close enough to ones that we embrace and referring to it as an international standard. The task is to get international standard-setting groups to come up with standards that come close enough to our own so that we could support what would then be called an international standard.

We support the efforts of an organization called the International Accounting Standards Committee to develop those quality international standards. The goal is to develop a comprehensive body of accounting standards that could ultimately be used for cross-border listings.

Now, the SEC works through an international group called IOSCO, which represents all the security regulators throughout the world, again to help develop international standards. And national standard setters such as our own FASB have made the international implications of accounting standards a vital part of what they're doing.

In the disclosure area, the Commission is working through COSRA and IOSCO to develop high-quality international principles and standards.

I think what is important is for us to convey to companies that resist this that we are prepared to try to work with them in the development of international standards, and we're prepared to help them cut through the red tape that they fear in the United States.

I guess the two greatest fears they have with respect to the Commission is they fear that the Commission is a bureaucratic impediment to coming to the U.S. markets and they fear litigation in the United States. They have a great concern about the burden of litigation when they come here.

A lot of this is salesmanship. When I left the American Stock Exchange, I thought I was through marketing listings. But I probably spent more time doing that since I've come to the Commission than I did when I was back in New York. With some success, I might add.

The CHAIRMAN. Just one other question, then I'll yield in the same order that we went before, to Senator Faircloth.

The SEC now has the authority to gather information on registered affiliates of securities firms that deal in derivatives. And I know you're working with the securities industry to establish voluntary standards for these kinds of affiliates. I'm wondering, the GAO has recommended direct regulation of these affiliates, with the suggestion that that would offer greater protection against systemic risks, and you commented on that question yourself in your earlier remarks. What do you think of that GAO recommendation and would direct regulation of those affiliates make sense, in your mind?

Mr. LEVITT. You know, I've experienced, as all of us have, a whole host of new products and new devices, not just in financial services, but in terms of American industry, in terms of developments in biotechnology and physics.

I view the development of derivatives as part of that process. It's a new, important product in the arsenal of financial services. It can have an enormous impact. It can have a devastating impact. It can also have an affirmative impact.

If you gave me a magic wand today and said that I had the power to eliminate derivatives from the American landscape, I would say that would be an economic tragedy. It would be a terrible mistake. On the other hand, to allow the development of this product to go unmonitored, both domestically and internationally, I think could create real systemic risks. We've already seen some warnings.

I'm a great believer that no tragedy comes out of the blue. It comes because lots of little signals come down the road and tell you, be careful. We're not always astute enough to pick up the meaning of those signals. I think we've seen some of them. We've seen them in the mutual fund field. We've seen them in the corporate market. We've seen them with individual investors. So it's incumbent upon us to take a very careful, close look at these issues.

Now what the GAO is calling for is legislation. I'm hard pressed to understand specifically what kind of legislation we might call for

at this time. I don't know how soon it would come or what it would result in. In the meantime, I think a lot of mischief could occur.

So before we go down that road, and I think that's a road that we have to carefully consider, I've asked Gerry Corrigan, who's going to appear before you in a few moments, and John Heimann of Merrill Lynch, to head up a task force of the 6 largest domestic derivative affiliates of securities firms to address this issue. I've asked that, before Thanksgiving Day, they develop standards relating to capital, internal controls, reporting requirements, and sales practices, standards that should be acceptable to the Commission and subject to suitable oversight, and standards that will address concerns about the activities of the unregulated derivatives affiliates of broker dealers.

I think that this exercise, if successful, would be unique. It would give the Commission a new pattern of oversight and give the industry the ability to kind of describe and develop with us their own pattern of oversight and regulation. I think that would be a landmark occurrence.

I can't tell you whether it's going to happen the way we expect it to, but we're working awfully hard to get that end accomplished before we go to the next step and either consider regulatory responses or call for legislative help.

The CHAIRMAN. I've a number of other questions I'm going to ask you to respond to for the record.

I want to go to Senator Faircloth now.

Senator FAIRCLOTH. Chairman Levitt, to follow with Chairman Riegle's question on derivatives, I have a little bit of a different concern about derivatives. I agree with you totally that to remove them from the financial scene would be a catastrophe, but I have a fear of the Congress attempting to overregulate something they don't understand.

I read the article in Fortune, Carol Lumas' article on derivatives, and it was a little frightening. What I fear is that the Congress—and of course, it's a complex financial instrument. But yet, overexcited and overregulated to the detriment of the financial community. Do you see that as a problem?

Mr. LEVITT. I do see that as a problem. If past history is a guide, you can predict the events that will precipitate that problem.

If the industry and the Commission are not able to promptly come up with the kind of regulatory environment that I think would be reassuring to the country, and if an accident occurs, and I promise you, an accident will occur at some point in time, then the Congress will quickly address that issue in a way which might create the problem you anticipate.

Senator FAIRCLOTH. Small brokerage firms—I hear constantly from individual brokers in small firms have great fear and perceive as a problem that the programmed trading is a great detriment to the individual investor. Do you see programmed trading tending to whipsaw the market to the disadvantage of the individual investor?

Mr. LEVITT. You know, a quick look at our markets might suggest that our markets have become substantially more volatile than ever before. I think that's not accurate. I don't believe that our markets really are, over a period of time, any more volatile. As a

matter of fact, I think they're less volatile than they have been in recent history.

Program trading is part of a series of investment strategies that have been developed in recent years. I think that, initially, they had a more dramatic impact on our market than they have today. The markets have tended to adjust to them and I don't regard program trading as an overwhelming threat. I think it's something we have to keep our eyes on because hardly a day goes by when some new device doesn't appear. Yesterday's program trading is different than today's and possibly from tomorrow's.

So I don't mean to sound complacent about it, except I don't regard that as being a serious systemic threat at this point in time. I hope I don't have to eat those words.

Senator FAIRCLOTH. I think I can anticipate your answer to this, but I want to bring it up, anyway, because it's something that bothers me.

The SEC collects a lot more in fees than it spends on security law enforcement and regulations. This goes into the general fund to support the welfare state and all other things. These extra fees are nothing more than one more tax on capital. Wouldn't the securities industry be more competitive if we were to make the SEC a self-funding agency and not set fees any higher than the regulations we need to produce the money we need to run the SEC?

Mr. LEVITT. Yes, sir, it certainly would. I think it is so important to move in that direction; it relates to fairness to the system that we regulate. I think all of the self-regulating organizations, the brokerage firms and America's investors, feel this way. Their interests would be served by seeing to it that the revenues of the Commission are more predictable and based upon actual services that are delivered and fees that are derived from delivering those services.

Senator FAIRCLOTH. I certainly agree. The very idea of taxing the capital industry—and any time you apply a tax, you make it less competitive.

Inflation seems to be picking up. Since we do not index capital gains for inflation, a rise in inflation equals a real increase in the capital gains tax.

If we're going to stay truly competitive as a Nation, do you not think we need to keep the real rate of capital gains taxation down, and since we don't index taxation of capital gains for inflation, doesn't that mean keeping up the fight against inflation?

Mr. LEVITT. I probably shouldn't answer this question because I have enough controversial issues without getting into taxation. But I do believe that the capital gains tax is a burden upon American entrepreneurship. I would hope that the Congress would be proactive in terms of considering alternative ways of looking at our tax code, rather than the kind of patchwork quilt that has been cobbled together through the years, through a system of political compromise and actions in response, reactive actions rather than proactive actions.

I think the Nunn-Domenici proposal is one of a number of very interesting proposals to look at which can try to bring some change to the way we tax capital in this country.

My answer to your question is that I think the Congress really should make an effort to reduce the burden of the capital gains tax.

Senator FAIRCLOTH. I would certainly support that. I came to the Senate with one absolute commitment, and that was that I would not support any tax increase under any condition. We have enough money, we're just not spending it as wisely as we might.

I've overrun my time, and I thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Faircloth.

Senator FAIRCLOTH. Mr. Chairman, I do not want to pour more syrup, but I want to thank you for the job you have done throughout the years and especially the job you've done since I've been here and the courtesy, guidance, and leadership you've shown to me. I thank you.

The CHAIRMAN. You're very kind. I'm going to miss everybody on this Committee, I'll tell you that.

Senator Shelby.

Senator SHELBY. Mr. Chairman, there's no more syrup in the room. But I just want to tell you, I believe you've been a fair Chairman. You've gotten a lot of things done. I've talked with you privately and publicly, and we're all going to miss you here. But we think you'll be around more than you realize at this point.

Chairman Levitt, I appreciate your candor a minute ago in your answer to the question on capital gains. You should have answered that question as you did because you bring to your office, your present office, a lot of experience, a unique background.

I have thought, as many people have thought for years, that if we're going to unleash the energy of entrepreneurs and everybody else in this country, we have to knock out the impediments from the capital gains tax. And I commend you for that.

I want to talk to you about the markets generally. You bring to this office as Chairman of the Securities and Exchange Commission your background as the former head of the stock exchange, which is unusual.

There is a risk in the marketplace. We all know that. But there is also a reward. That is why people are in the market. People try to hedge, which is human nature, try to hedge their risk, and at the same time, hoping to get their reward.

Isn't some of that programmed trading and derivatives and so forth—that is why we've seen such a proliferation of growth, not only coming out of Chicago, but everywhere else in the world—because people were interested in how can I protect my risk in the market sometimes, and a lot of times it backfires, and a lot of times it works. It depends on the sophistication and perhaps luck sometimes of the investor, doesn't it?

Mr. LEVITT. Absolutely. I think that, in many ways, these products have been enormously constructive in terms of balancing risks and adding liquidity to a market.

Senator SHELBY. But doesn't a market, in a sense, take care of itself, correct itself? In other words, regulates itself.

If I'm in the market and I get burned on some derivatives that I shouldn't have been in because I didn't understand, but shouldn't have been in to begin with, I think I'm not going to get in those markets or buy those same instruments down the road. And if I do, I'm pretty much of a fool.

Doesn't the market take care of itself, to a great degree like that, barring fraud or anything else?

Mr. LEVITT. That's kind of the ultimate economic Darwinism. And I suppose that's true.

Senator SHELBY. But it's true, though, isn't it?

Mr. LEVITT. Yes, it is true.

Senator SHELBY. It might be brutal, but it's true.

Mr. LEVITT. It's true, but it's limited.

Senator SHELBY. What do you mean by limited?

Mr. LEVITT. Well, for instance, before we had such things as short-selling, certain investors wouldn't access the market, wouldn't use that device. What I'm suggesting is that some of the new products, some of the new devices have added liquidity to our markets by bringing investors in who would not otherwise have been there.

Senator SHELBY. Absolutely.

Mr. LEVITT. And that liquidity, I think, is useful.

Senator SHELBY. A lot of people try to give derivatives a bad name. They say, oh, gosh, they're trading in derivatives. But what they really need to look at is what is underlying, what is the instrument underlying what they're trading, isn't it?

Mr. LEVITT. Yes.

Senator SHELBY. A lot of people—I know some sophisticated investors, or we thought they were sophisticated—have been burned in the derivatives.

But some commercial banks have gotten into investment banking and obviously haven't known a lot of what they were doing.

You've seen some of that, haven't you?

Mr. LEVITT. Yes, sir.

Senator SHELBY. So when we talk about and you hear about how is Congress going to regulate the derivatives market.

My question, I guess, is similar to some others here. How can we in Congress, or the staffs that we have, try to regulate something that's changing every minute and is so sophisticated and much beyond our realm up here as legislators? How can we do this, or will we be interfering in putting an impediment into something that is going to grow, anyway? If we try to regulate it here, and the rest of the world, they don't regulate it—in Tokyo, in Frankfurt, in London, in Paris, in Hong Kong, or in Singapore, you name it—what good do we do? Or do we do our people a disservice?

Mr. LEVITT. I think that there's a real danger in trying to seek a so-called quick legislative fix to the problem. However, if again there is an accident and——

Senator SHELBY. Let's talk about an accident. Just suppose so. Just supposition.

Mr. LEVITT. A major institution fails as the result of the improper use of derivatives. That sort of accident I believe would trigger off a legislative response.

Senator SHELBY. It shouldn't always do that, should it?

Mr. LEVITT. No, it shouldn't. It certainly shouldn't.

Senator SHELBY. You're probably speaking in political parlance—it probably will.

Mr. LEVITT. Yes, that's exactly right.

Senator SHELBY. But it shouldn't necessarily because if we stayed out of it, the market would regulate itself, wouldn't it?

Mr. LEVITT. I think we are on the course to creating protection against a systemic problem. I can't assure you that we will arrive at that happy day.

Senator SHELBY. How are you going to do that? How are you going to protect people who don't want to be protected or don't know if they want to be protected or don't understand what they're getting into?

Mr. LEVITT. It's very, very difficult.

Senator SHELBY. Very much.

Mr. LEVITT. What we're endeavoring to do is to work with an industry that I believe is sensitive to their responsibility and also to the dangers involved, and to come up with the kind of regulatory pattern that is most likely to protect the economy from a systemic rupture.

Senator SHELBY. Like what, for example? Come up with a regulatory pattern. When we start talking about regulations——

Mr. LEVITT. I'm really talking about oversight.

Senator SHELBY. These things bother us up here. Some of us, anyway. Regulations.

Go ahead.

Mr. LEVITT. What I'm talking about is the ability for the SEC, your agency in that connection, to develop standards relating to capital and internal controls as far as the major users of domestic derivatives are concerned. And standards in terms of suitability, an agreement between ourselves and the firms in terms of what kind of suitability is appropriate.

It's along that line that I think is a basic frontier protection against the systemic problem which would create the kind of response which neither you nor I really look forward to.

Senator SHELBY. Mr. Chairman, I know my time is up. I just want to ask one brief additional question. About how much money is tied in the global trading dealing with derivatives each day? Just a guess. A lot of money. You don't want to guess?

Mr. LEVITT. I don't want to guess on that one.

The CHAIRMAN. They've got the adding machines going out there. They can't go fast enough.

Mr. LEVITT. Maybe Gerry knows.

Senator SHELBY. Leo, do you have any idea?

Mr. MELAMED. Well, it's very difficult.

Senator SHELBY. I know it.

Mr. MELAMED. The notional values—it's very difficult to answer.

Senator SHELBY. But you're talking about trillions of dollars, anyway. The instruments that these derivatives are predicated on is trillions of dollars, isn't it?

Mr. MELAMED. Oh, absolutely. But that's not the way you measure the risk.

Senator SHELBY. How do you measure?

Mr. MELAMED. It's a netted thing.

Senator SHELBY. OK.

Mr. MELAMED. The netted risk may be something like 5 percent.

Senator SHELBY. Of the whole thing.

The CHAIRMAN. Five percent of $10 trillion.

Mr. MELAMED. Yes.

Senator SHELBY. But it's important.

Mr. MELAMED. But it's still a lot of money.

Senator SHELBY. Thank you.

The CHAIRMAN. Well, we'll have you up here at the table a little later because this is an issue of keen interest to everyone and we're all trying to understand these changes that take place.

Senator Domenici.

Senator DOMENICI. I'm going to go now and I can't come back.

The CHAIRMAN. Please.

Senator DOMENICI. So I'll wait just till the last minute to leave, then I must say to the other witnesses, I can't come back.

Let me say to Felix, I read your testimony and I agree with you that the most significant issue around right now is what's happening to the value of the dollar in the international markets.

I think it's obvious that it's a very, very serious problem, but it's also serious because nobody seems to have a real reason for it being the way it is or a way to fix it if it needs fixing. You've suggested four or five, and I thank you for those and I note them.

Mr. Chairman, let me suggest that your appointment of a task force, if that's what you called it, on derivatives is a fine idea. And frankly, I'm only concerned as to whether or not it's—and forgive me, I cast no aspersions on you or the SEC, but this is such a serious problem because we're apt to overreact if we don't get some good advice. You see, we have a premise. Maybe it's a premise that permeates all democratic legislative bodies, but it's very simple. It's anything worth doing is worth overdoing. That's us. And so, if we get in this field and we don't have the very best of advice, or if we push ourselves into it when we shouldn't, we're going to make a big, big mistake.

My only concern is whether the task force will be broad-based enough and whether you think when it comes up with its ideas, they're going to be acceptable to a broad base of those who would look to it for advice? And I'm not second-guessing you. I'm just laying that before you as something that is very important.

Mr. LEVITT. I'm not sure yet. I believe that an earnest effort is being made. All of us are obviously mindful of all players on this scene. And clearly, we will expand our efforts if it is appropriate.

I believe that the scope of what we're doing is ambitious, but I think it is responsive to what I regard to be the most serious problems that we face. I would certainly, in the event that we are successful in working this out in the timetable that I've discussed, I would come before this Committee and other Committees of the Congress to urge them to let the process work without entangling us in a legislative morass.

Senator DOMENICI. I appreciate that and I appreciate your observation with reference to it.

Let me make one further observation regarding risks. This sounds very parochial on my part, and I think your task force already knows this, but I want to lay it before you and put it in the record.

Believe it or not, probably the most significant capability in supercomputers exists at one of the laboratories that made our nuclear bombs. Los Alamos National Laboratory is the laboratory that forced the CRAY computer on the American economic scene. They were the demand pull for the invention of the supercomputer. They

needed computing nobody could do and they said, let's get it. And so, they were the pull.

They have their experts currently engaged in exercises on risk. Frankly, they have turned to the banking industry and to derivatives in terms of looking at them with the greatest minds and computers in the world. That may be the kind of thing that ultimately we've got to look to determine what risk really means. Then maybe we'll have answers to how much per day is out there and the questions that were asked. You can't get them without that, I don't think.

Mr. LEVITT. I've been out there and we've been in touch with them on this very subject.

Senator DOMENICI. So you already know that they're pretty capable in that field.

Mr. LEVITT. They're extremely capable.

Senator DOMENICI. Could you give me a quick response to a question which is a little bit out of your area. I think you know something about it. How serious is the dollar devaluation in the world banking markets, in particular, German and Japanese, and what do you attribute it to?

Mr. LEVITT. I think it is serious. I don't know exactly what the answer is. I haven't read Felix's testimony. I'll be interested to hear what he has to say about it.

Senator DOMENICI. Let me ask—maybe the Chairman knows, our Chairman, but just for 30 seconds. What is the suggested solution that the House has come up with for the full financing of SEC, full year's funding? We did not fund it fully in the Appropriations Committee. We couldn't because no authorizing language had been passed. What are they recommending? I want to be able to tell you right now whether I'm going to support it or not.

The CHAIRMAN. I'm going to let Chairman Levitt answer that because I think his knowledge is probably better than mine.

Mr. LEVITT. The House passed a bill yesterday that keeps our fee at exactly the same as it was before, which is one twenty-ninth of one percent. It's over in the Senate now. There are no other changes other than that, just to get us through the coming year, during which time we hope we will work out a more long-lasting solution to this.

Senator DOMENICI. So that avoids the issue of self-financing and all those other troublesome ones.

Mr. LEVITT. Yes.

Senator DOMENICI. It just establishes the rate.

Mr. LEVITT. The Appropriations Committee worked with us in developing that.

Senator DOMENICI. I'm hopeful, if that's the case, that we get it out of here.

The CHAIRMAN. That's our intention. We've been working with them to try to find a path, a workable path, here to accomplish this. And so, while it's in an Appropriations bill, it's something that we have been a party to helping to craft.

Mr. LEVITT. Senator, one final point on this.

Senator DOMENICI. Please.

Mr. LEVITT. It's really essential that we get this done by October 1st.

Senator DOMENICI. Right. Well, I don't know. We did fund you. One estimate is through February and the other is through January. But we're sure you're funded.

Mr. LEVITT. But if we didn't get this funding, if this didn't get accomplished by October 1st, we would begin to have to send notices out. Even though it would be remedied, it would have a devastating impact on the members of the staff.

Senator DOMENICI. Mr. Chairman, I want you to know as the Ranking Member on the Appropriations Committee that limited their funding, we had no alternative because there was no law in place and neither the House nor the Senate would pass one. If this fixes it, you have me as your ally as soon as this is ready. I will join you.

The CHAIRMAN. Good. I appreciate that.

Senator DOMENICI. I want to make one last observation. Sometimes we're looking at issues with reference to liquidity that are very, very complicated. But right down on Market Street and Central Avenue and the business communities in our cities, there are just two issues on liquidity that are very simple and fundamental. One has to do with why there is not a major secondary market in commercial real estate loans. And second, why there is not a major market, secondary market, in bundling of small business loans without such a secondary market, the local banks have to carry most of that and liquidity is greatly, greatly diminished.

I want to suggest to all of the experts here, this Committee has started down the path of increasing the liquidity in both. We have eliminated all of the impediments to the bundling and the creation of a secondary market with reference to commercial loans, and we've also done the same for small business loans.

I'm very hopeful that the market will begin to respond to that. I'm merely suggesting to you and the others here, that if what we did is not sufficient to get that going, we sure would like to know quickly because there is a genuine interest in making that part of the market much more liquid.

I think you all would agree that that would be very helpful here at home.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Domenici.

I'm going to read one final question into the record and then I'll have to excuse myself because the voting time period will expire. But it's an important question and I want to say it to you directly, and then I'm going to have you answer for the record. I'll have some other questions for you as well.

In his testimony, Gerald Corrigan predicts, and I quote: "No near-term relief from the patterns of increased market volatility and short-term exaggerations in price movements."

You touch on volatility, but I didn't get the impression that you think that it's increased. I don't know that you've stated that clearly one way or the other. But given his comment, which we'll probe a little bit later, do we have adequate tools in place today to deal with market volatility? And why do we have disagreements, if there are disagreements here, on what the level of volatility is?

I'm going to let you think about that and I'd like a careful response and then I'll be probing him when he comes to the table as to what his view is in his prepared remarks today.

But let me now put the Committee in recess. I'm going to excuse you as a witness, and then when we come back, we'll start with our other three witnesses.

Thank you.

The Committee stands in recess.

[Recess.]

The CHAIRMAN. The Committee will resume. Let me welcome our other witnesses to the table and again, thank you for coming today and for being part of this discussion that has been set in motion by SEC Chairman Levitt.

Mr. Corrigan, we're going to make your full statement a part of the record and we'd like to start with you, and we'd like your comments at this time.

STATEMENT OF E. GERALD CORRIGAN, CHAIRMAN OF INTERNATIONAL ADVISORS, GOLDMAN SACHS & COMPANY, NEW YORK, NY

Mr. CORRIGAN. Thank you very much, Mr. Chairman.

I don't want to get back to syrup, but I do want to make a comment or two of my own in that broad category. And that is to say, Mr. Chairman, that my own personal dealings with you as Chairman, and with the Committee as a whole, even when we've had to deal with some tough, tough issues, you've always, I think, been a source of satisfaction to me. Under your leadership I have viewed the work of the Committee as constructive, productive, fair, open, and with a very generous spirit of bipartisanship. I think you deserve a great deal of credit for that. It's been fun.

The CHAIRMAN. Well, thank you.

Mr. CORRIGAN. Mr. Chairman, I know time is short. I have prepared a rather lengthy statement, part of which deals with an important set of relationships in the area of global finance. I will not even try to get into that this morning, except to make one or two general points.

First of all, on a philosophical level, I do think that it should be noted that one of the benefits that grows out of globalization of finance is that it has the potential to build better understanding between nations.

In other words, if we can get it right, which will not be easy, globally integrated finance and financial markets can help to provide some of the glue that can constructively bind together the nations of the world in what we all hope will be a period of sustained peace and prosperity. That aspect of the issue should not be lost.

I think it's also very important to recognize, without going into a great deal of detail, that the international financial markets, whatever else they may be, are the instrumentalities that must equalize savings and investment on a global scale.

They are also the instrumentalities working through exchange rates and interest rates that must readjust financial flows among deficit and surplus nations.

I don't need to remind you or this Committee that one of our problems as a Nation right now is that we are a rather large deficit Nation.

I think that, in looking ahead, keeping in mind that absolutely essential identity of global savings and investment, we must recognize that there are some potential problems out there.

In the context of growing economies here and elsewhere, there is, for example, a question as to whether we may be looking at a period ahead in which inflation-adjusted interest rates—so-called real interest rates—may be somewhat higher than historical benchmarks might otherwise suggest.

Even more importantly, the question also arises as to whether the market-driven process of reallocating savings within and among nations may widen the gap between economic haves and economic have-nots.

The consequences of such an eventuality could over time have distinctly troubling implications—economic, social, and ultimately, political terms as well. In other words, I think it's important to keep in mind that even the very best of international financial markets and institutions can only do so much.

For example, myopic trade policies, efforts to regulate or control capital flows, or, and especially, continued large-scale governmental dissavings in the form of budget deficits at the national level, such as we have in the United States, could produce a situation in which the period ahead will be extraordinarily difficult.

I can see no possible framework of broad-based economic progress unless it occurs in a setting of true openness in trade and finance and sustained discipline in monetary and fiscal policies.

Unfortunately, I fear that we are a long way from those ideals, even though efficient markets may paper over these problems for a while, in the fullness of time, the marketplace will treat harshly even the largest of nations that fail to conduct their economic financial affairs in a solid and prudent way.

Now there's a great deal of discussion also in my statement, Mr. Chairman, about a point that was emphasized by Chairman Levitt which I need not repeat, and that is to say that the U.S. financial sector as a whole, our capital markets in particular, are the unquestioned world leaders, and we've got to keep it that way.

I do want to mention very briefly in closing two or three points that I think are germane to the question you raised earlier in terms of what should be on the radar screen.

The first is to pick up the point that you already made. I can see no near-term relief to the patterns of increased market volatility and short-term exaggerations in the price movements of financial assets. To an important degree, and especially in times of stress, these tendencies are amplified by a degree of linkage in asset price movements across markets and across national boundaries that seem to defy the so-called fundamentals, at least in the short run.

There are a lot of different explanations given for this which I've touched on. I do want to touch here just again briefly on the question of derivatives.

I am myself agnostic as to whether derivatives cause this volatility because I think you can make a case that they may actually reduce it. But I do completely agree with the point that there are

legitimate issues in the area of systemic risk that arise in the context of derivatives, and I have attached to my statement, Mr. Chairman, a six-point program that I outlined in testimony earlier this year that I think will get at the problem and in a sensible way over time without legislation.

The second point in your reference to radar screens that I mentioned is a concern I have for what I call—I can't think of a better word—the potential problems of market disintermediation.

We all got used to that term, disintermediation, in the Reg Q days in a different context. But what I have in mind here, Mr. Chairman, is the danger that an economic, financial, or political shock can trigger an abrupt change in market psychology which gives rise to a major shift in investor preference for a generic class of assets, such as high-yield bonds, mortgage-backed securities, emerging-market debt, or country-specific debt or equity in a particular circumstance.

And as I suggest, to the extent that such markets are or become illiquid, this phenomenon that I call market disintermediation can take on cumulative characteristics. I suggest a couple of things that I think can be thought about there.

The third point, again in the context of radar screens that I mention, is what I would suggest respectfully is the need to rethink the regulatory and supervisory philosophy. Again, the point I think here is that while efforts aimed at regulation of securities markets and securities firms, going back to the 1930's, in the United States have been truly outstanding, that there are aspects of the underlying philosophy going way beyond the question of investor protection that need some fresh thinking.

I'll stop there, Mr. Chairman.

The CHAIRMAN. Thank you for your full statement and for its detail, and also for the summary you've just given us.

I'm going to go right down the table. Mr. Rohatyn, you're next up in the batting order. We're pleased to have you. We'll make your full statement a part of the record. We'd like your comments now.

STATEMENT OF FELIX G. ROHATYN, SENIOR PARTNER, LAZARD FRERES & COMPANY, FORMER CHAIRMAN, MUNICIPAL ASSISTANCE CORPORATION, NEW YORK, NY

Mr. ROHATYN. Thank you, Mr. Chairman.

Again, I would like to join in thanking you for all the work you did as Chairman of this Committee. I'd like to thank you personally for your friendship and your support every time I've appeared in front of this Committee.

I obviously want to recognize a great debt that I and the City of New York have to this Committee for the work that we did together in resolving the last fiscal problems of the City of New York—I hasten to add, the last one.

I will summarize my summary, Mr. Chairman, and look at this a little bit from the point of view of the global market economy as it reflects on some U.S. problems.

I believe that it is critical to have very strong world-wide economic growth—that means economic growth in the developing world—in order to have sustainable minimum growth levels in the West.

I think that in order for that to happen, the amounts of capital required to finance that growth in the developing world, in my judgment, are far in excess of what can be supplied only by the West and therefore, require the developments of large, liquid, transparent markets in developing countries like China, India, Mexico, et cetera.

There are markets there that are existing today that are growing. I think these markets have to be interconnected systemically with the markets of the West, which are far more advanced from both a technical and a legal infrastructure point of view. And I think that is something that has to be addressed reasonably soon.

The fact that the size and the power of these global markets are as great as they are I believe require compatible securities and banking regulations, and at the same level, on a world-wide basis, great attention has to be taken to the levels of speculation and somewhat little understood off-balance sheet risks that are present today in the system.

Having said all that, I believe that the key to the stability of the world's financial system today is the strength or weakness of the U.S. dollar, which underlines the whole system. I believe that's true for essentially three reasons as far as this country is concerned.

First, that a weak dollar is inflationary and the higher prices for imports cause domestic producers to raise prices.

Second, that a weak dollar makes U.S. investment abroad more expensive, and in an interconnected economy, that's bad for our competitive position.

But third, and most importantly, that a weak dollar has a very negative impact on the huge financing and refinancing requirements of the U.S. Government.

I think it's worthy of note that when the national debt grew from $1 trillion to $4 trillion over the last 12 years, that a huge refunding calendar has been created for the 1990's, partly also as a result of the shortening on the national debt that has been done for the last few years.

I believe that a total of about $2 trillion of Treasury bonds and notes have to be refunded over the next few years, to which you have to add the deficit that will have to be financed during that same period of almost a trillion.

Now, historically, almost 30 percent or a third of our Treasury financings have been financed by foreign purchasers. And over the last couple of years, as a result of the weakness of the dollar and concerns about the economy, these foreign purchasers have pulled back from the support of these financings, especially the Japanese. When you combine that with the existing outflow of American capital to the emerging markets, you're creating a potential problem of great importance.

I think strengthening the dollar in order to continue to incentivize foreign investors to help finance the national debt so that we don't apply all of our savings to that financing can only happen, really, in two ways. We need a strong dollar and continued confidence, coupled with reasonably low-interest rates. Or if we can't do that, we will have constantly escalating interest rates to offset

anticipated losses due to a weakening dollar. And the latter scenario obviously would be very negative to the U.S. economy.

My conclusions are as follows:

First of all, a financial crisis, if it starts, and if it were to start as a result of a run on the dollar, is more and more difficult to stop in view of the amounts involved in these capital flows.

I think monetary policy alone can't deliver growth, low-interest rates, and a strong dollar when the world markets say otherwise.

In order to be safe, I think we have to try to do those things that are in our control to do; namely, to reduce our borrowing requirements, to strengthen the dollar and lower interest rates, to reduce the pressure on the capital markets. The only way I believe this can be done, or at least attempted with any hope of success, is with sustained and continued reduction in the budget deficit.

I don't believe this is the time for any tax cut of any kind in view of that situation.

I believe one of the ways to do this would be to support the Kerrey-Danforth Commission, which has been created to try to cut entitlement programs, and to come up with a program that over, say, a 5-year period, you'd have a credible program to balance the expense budget, and I also believe that the budget of the United States should be separated between an expense budget which should be in balance and a capital budget against which you could have some borrowings.

Second, in order to integrate these capital markets, I think there should be some type of international organization like GATT to deal with investments and investment criteria, in order to provide arrangements so that Western investors will get the kind of protection that they require if they continue to make large amounts of capital available overseas.

The United States is the largest capital market in the world. I believe it's in a position to propose international procedures to protect investors, and I believe we could condition this on happening over a finite period of time by, in effect, potentially limiting the ability of U.S. fiduciaries to make investments in areas or countries where that protection isn't provided.

Third, as a practical matter, I think it's worth noting that we're encouraging countries all over the world today to adopt capitalism. But the type of capitalism that we're encouraging is too often what I might call, Cowboy Capitalism, of the kind that we practiced at the turn of the century. Our capitalism has gone through almost 100 years of amendments, of legislation, of regulation, of new institutions, many of them coming out of the Depression and of the legislation of that period.

This is a very complicated system and I think the U.S. Government should form some kind of a permanent task force that would consist of representatives of the SEC, of the Justice Department, of the Fed, of the various agencies, that could provide assistance to foreign governments which need this type of assistance on a coordinated basis.

I think it's wonderful to have Gerry doing this in Russia. I think it's wonderful to have other people doing it. I think this should be part of an integrated system and somebody like Gerry Corrigan could obviously head that system.

In conclusion, I would like to make another point.

The CHAIRMAN. I think he's prepared to volunteer you, just as you are prepared to volunteer him.

Mr. ROHATYN. Well, I'll go where he goes.

[Laughter.]

The CHAIRMAN. I see.

Mr. ROHATYN. I'd like, in closing, to say that if there is a new world order today, it's in finance and economics. It is driven by globalizations, by communications, and by technology. But because it's very new, I believe it to be extremely unpredictable. I believe that the current arguments as to the trade-offs of growth, unemployment, and inflation are to me an example of conventional assumptions.

I don't see the empirical evidence that 6-percent unemployment is the lowest tolerable level of unemployment without inflation. That may be true and Gerry believes that it is, and I'm open to conviction, but I'm not convinced and I don't believe the case has been made.

I don't know that anybody knows how much capacity has been added to the United States economy after 10 years of restructuring, or what the impact of foreign competition and wage rates on United States costs are. I would urge a great deal of skepticism and care in making assumptions that I believe may be totally changed by what is happening in the world today.

So, in conclusion, again I thank you for the opportunity of appearing here because I think these are very important issues. I think these markets, I agree with Gerry, are going to be increasingly volatile and, at the very least, stay extremely volatile. And I think there is always a risk because of these markets being as huge and as volatile as they are, that some shock would create a real problem.

As we approach the 50th year of Bretton Woods, I think all of the financial institutions, not only of the United States, but worldwide, should be subject to review. And as we face the turn of the century, that we try to accentuate the best impacts of global capitalization and try to protect ourselves against the dangers that some of these trends may create.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much. A little personal aside before going to Leo Melamed. In the industrial base and in the automobile industry, we saw some years ago the effect of a globalized system, globalized manufacturing, trading, competition, what have you. And as a result, at least those of us who were dealing with those issues had a chance to see what happens when the world comes on line, with all of its unique factors in terms of trading practices, currency values, the value of the dollar, and a lot of other things.

I'm struck by watching now what's happening with respect to the globalization of financial markets. That's been going on for some period of time. But some of the things that are in part at least analogous to what I believe I've seen and experienced, and we've experienced on the industrial side.

The reference point in terms of today's news is that after having the domestic auto industry go through all of its turmoil and

downsizing and restructuring and so forth, the lead story in The Wall Street Journal today comes from my hometown of Flint, where the Buick motor plant is on strike because the workers are working too much overtime. They're working so many hours because of the plant capacity issues of scaling down and now having models that are so popular, that we can't build enough of them with the work force that we now have.

It's not just a GM problem, fortunately. It's the good fortune of all the domestic manufacturers right now to sort of be up against production bottlenecks in terms of being able to supply domestic demand. But it's just a little reference point that hits home with me and because it's in today's news, that we've come full cycle now where we're doing pretty well in that industry, but the workers are in effect saying, we've got to have a little breathing space sometime in a 7-day week in order to keep going and produce cars up to the level of quality that is required.

So I guess these issues never quite go away. They change their size, dimension, and complexity as we go.

Mr. Melamed, thanks for coming in today and being here. We've gone through a lot of things over the years. I remember back in 1987, when we were on the phone together, as things were sort of upside down, at least for a while.

We'll make your full statement a part of the record and we'd like your comments now.

STATEMENT OF LEO MELAMED, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, SAKURA DELLSHER, INC., CHAIRMAN EMERITUS, CHICAGO MERCANTILE EXCHANGE, CHICAGO, IL

Mr. MELAMED. Thank you, Mr. Chairman.

Let me begin by stating that it's difficult to follow so distinguished a panel. I find that it may be difficult not to reiterate much of what the panelists have already stated.

With respect to your leadership of this Committee, I particularly wish to echo and add to the comments of the others.

On a personal note, I remember quite vividly that awful day in October, 1987, when you and I spent so much time on the telephone together throughout the day and the night. It was to the credit of the leadership of yourself and this Committee that prevented unnecessary legislation following that shock and that awful period of time. As a result, the industry worked to develop the kinds of safeguards that needed to be implemented, and that were implemented as a result of this Committee's guidance.

I'll never forget that awful time, nor the contributions made by you and this Committee during that very difficult emergency.

I personally wish to thank you for all that you have accomplished during this period.

The CHAIRMAN. Well, thank you.

Mr. MELAMED. Mr. Chairman, allow me to summarize my statement by stating that we all have been talking about globalization for nearly 20 years. But recently, globalization really happened in quite a different way.

We are now in a unique position in the world because every nation has adopted or is in the process of adopting a capitalist market economy. That was not the case as little as 5 years ago. Suddenly,

we really are talking about a market economy on a global basis with nearly 70 percent of the world's population involved. This means that nearly every nation is competing for capital.

As a consequence, the United States finds itself in a much more difficult competitive position than ever before, even as recently as only 5 years ago. That share of capital is going to keep on shrinking as emerging nations suddenly become capital-demanders instead of capital-providers.

Just 5 years ago, the emerging nations exported capital. Whereas, in 1993, emerging nations had a capital inflow of nearly $110 billion. The rebirth of nations' stock markets around the world, while it has an enormously positive effect for the world, has put demands on capital around the world.

Market economies all over the world are now competing with the U.S. for capital. This is not going to make it easier for the U.S. to maintain its leadership and will put burdens on us that we never before had. And because we've been the capital of capital markets, it really puts it to us because suddenly, there are competitors that we've never seen before.

One of the primary instigators of all the events that have transpired over these last 10 years has been technology which has evolved and served to revolutionize the world.

In information-based technology, the results have been overwhelming. In a political sense, of course, they've been extremely positive—in the fall of communism, the breakdown of the Berlin Wall, to the undoing of apartheid.

All of that I would attribute to the technology that made it impossible for a government to hide the truth from its citizens. Modern telecommunications provided citizens the ability to judge their governments, compare their economic systems, examine their moral codes, scrutinize their cultural freedoms, and weigh them against those of other nations.

The CHAIRMAN. I might just say, if you'll permit me, in going back to when the Berlin Wall was in place, if a person travelled on both sides of that wall, you got the feeling that it wouldn't last forever, and it sure didn't, because of that stark contrast.

Mr. MELAMED. Exactly. Technology has also had a similar effect on almost everything in life from science to finance.

In science and in finance, technology has caused us to go from the big to the little. We used to talk about general relativity in physics we now talk about quantum mechanics. The atom used to be considered the smallest particle of matter. We know now of smaller—the quark.

In biology, we used to look at the cell, now we have gene engineering. The cell, we now know, is like a high-tech factory in which complex chemical reactions produce substances that travel via networks of fibers. We have also moved to gene splicing and gene engineering as a result of technology.

In a very similar way, the same thing has happened to finance. It's not surprising.

Derivative are in a way the equivalent of particle physics and gene engineering. What the computer has allowed finance to do is to break down risk into its separate components.

Intricate calculations and state-of-the-art analytical systems ensued, offering financial engineers the ability to divide financial risk into its separate components. Derivatives—the financial equivalents to particle physics and molecular biology—were born. Consequently, investment methodologies were transformed from all-encompassing traditional strategies to finely-tuned modern portfolio theories, and long-term hedging evolved into on-line risk management.

Government officials who are now wrestling with the problems posed by the Age of Derivatives and other market innovations will find that it is nearly hopeless and counter-productive to attempt to harness their growth, prevent their invention, or regulate their application.

I certainly believe that the best way to handle the risks with derivatives is what is currently being attempted. I applaud Gerry Corrigan for leading that effort. The private sector should assume some of the regulatory burdens themselves and determine what types of standards are needed to control the internal risk of derivatives. This approach is greatly preferred over a legislative or regulatory solution, which cannot and will not work.

Finally, Mr. Chairman, there are two additional points I'd like to make.

First, Vice President Gore has assumed the role of advancing the United States toward the information superhighway. I applaud this effort. I, who have been involved in markets and market technology throughout my life, recognize how important it is for the United States to maintain its leadership in this area. For if we don't, it's going to happen anyway and the United States will be left behind. I believe that the information superhighway of today represents what the industrial revolution represented maybe 100 years ago. Information infrastructure is one way in which the United States can maintain its economic lead. Not only do we innovate, create, develop, and export telecommunications equipment, but we also lead in the application of those technologies.

Finally, I'd like to emphasize something that has not yet been said, but is very important.

As we close this century and are about to enter the 21st Century, we are facing a Pacific Era. That is something that perhaps is not yet understood.

John Hay, the American Secretary of State at the turn of this century, said it best. He said: "The Mediterranean is the ocean of the past, the Atlantic the ocean of the present, and the Pacific the ocean of the future."

The nations of the Pacific today represent the largest population center in the world. By its all-inclusive definition, it accounts for two-fifths of the world's surface and nearly half of the world's population. It is the geographical region with the potential of becoming the world's leading market force in the 21st Century. With a population ten times greater than North America, six times greater than Europe, and a faster growth rate than either region, Asia has the potential to overtake the other two regions economically before very long.

To take full advantage of the political and economic revolutions that have occurred in this region, to take full advantage of the po-

tential it represents, we must open our borders and facilitate international trade with the East.

The United States remains the overwhelming symbol of freedom, democracy, economic success, and opportunity to the people in Asia. We must nurture this view and build bridges of friendship and economic cooperation.

We dare not miss the historic opportunity that the next century and this moment in history provides us.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much.

Senator Moseley-Braun, did you have an opening comment that you want to make at this point before we go to questions?

OPENING COMMENTS OF SENATOR CAROL MOSELEY-BRAUN

Senator MOSELEY-BRAUN. Mr. Chairman, this is a distinguished panel of both a constituent and a friend. Mr. Corrigan, I have not had a chance to visit with you, but I certainly have had conversations with two of the members of this panel about some of these issues over time.

At the outset, Mr. Chairman, I'd like to commend you for holding this hearing. This is a very appropriate time for us to review the condition of U.S. capital markets and the internationalization of world capital markets.

Happily, our financial system is not in crisis right now. It is healthier than it has been in many years. This is a good time, therefore, to take a look at the long-term trends and to consider whether any policy changes are needed to ensure the future systemic safety of our financial system, and to ensure that the evolving system is able to meet the financial needs of all Americans and of the American economy during this time of rapid and fundamental change.

We clearly have a distinguished group of witnesses before us this morning and I have been following the testimony, Mr. Chairman, on the magic eye in this room. I must tell you, I've been very impressed with the thoughtfulness of the comments and the discussion and the conversation that has occurred this morning.

I have a long statement which I will file, Mr. Chairman for the record.

The CHAIRMAN. It will be printed in full, without objection.

Senator MOSELEY-BRAUN. Thank you. There has been a lot of discussion in literary circles recently of the newly found manuscript by Jules Verne. He wrote 100 or so years ago a futuristic book that was locked in a safe all this time. It turns out that he predicted a lot of things that we take for granted—fax machines and cars and the like. The question becomes what good would it have done us if we had had the benefit of those visions or those predictions to guide us along the way?

I think that part of the value of this kind of discussion is that we don't have the answers to what to do about these changes. We don't know really what quarks with color and flavor really impact on our understanding of physics and whether or not derivatives really are going to be the beginning or the end of trading as we've known it.

But the point is that I think it's important that we have a dialog about these issues and that we have the best minds we can bring together to talk about these issues to try to give us guidance, to give us a road map, so that we can begin to make certain that our role as Senators on this Banking Committee, our role as representatives of the interests of all of the people gets discharged fully, that we are able to take into account what's happening in the private sector and, therefore, make certain that our policy decisions are responsive, are perceptive, and do no harm.

I think that is the admonition that's given to doctors that ought to be given to all of us as well, which is do no harm. If we can do the best we can to make certain that these changes benefit all the people—benefit the little guys in the communities who want to build a house or who want to start a new business—an entrepreneur who just needs $5,000 to get started.

Really, in the final analysis, there are a lot more of those people and we have to make certain that the changes in the decisions in the policies that we make impact average working people in a positive and in a constructive way, and that we can keep capital flows functioning in a way to keep our economy healthy for everyone's benefit and in everyone's behalf.

I want to welcome the Members of this Committee this morning and I again want to compliment and commend you, Mr. Chairman, for convening this hearing. The timing could not have been better and the testimony could not have been better put.

The CHAIRMAN. Thank you. The issue of the budget deficit and how that plays back through the value of the dollar and the whole question of our position out in the world, around here, there's been some self-congratulation because we've reversed at least the path of the deficits. The deficits are coming down.

We did put in place a fiscal package last year that, in a sense, restrained the deficit. It didn't get rid of it, but it changed the path it was on and brought it down. It brought it down substantially. In fact, the data that we all saw just a few days ago indicated that the projections for the fiscal year deficit were coming in even below what they had been thought to be just a few weeks before.

So we made some progress. I'm trying in my own mind, just given the way that we do our budgeting—we don't have the expense in capital budgeting delineation, which we ought to have. I agree with that. But when we get fiscal deficits down in the range of $200 billion a year and you look at it both in absolute dollars and as a percentage, say, of GDP, where it was a declining percentage, not only because the GDP is growing, but also because the deficit has been shrinking.

What is the impact on the margin of $200 billion deficits when you look at them in that context? Not that I want them or anybody wants them and we want to get rid of them. But I'm wondering, on the margin, what the economic effect of that is as it plays through the system, as it plays through currency values having to bid for capital in a world where capital needs are growing and capital is scarce? Is the message that $200 billion is still so wide of the mark in terms of where we need to be, that it's gravely threatening to us? Do we have to try to bring it down faster? That gets

into the issues of you don't want to bring it down so fast that you tank the economy. The economy is doing reasonably well right now.

I would be interested in how you size today's deficit and trendline in the context of its overall macro-economic effect. I'd like to start with you, Mr. Corrigan.

Mr. CORRIGAN. Senator, let me try and take that in a couple of quick bites.

First of all, I do very much agree with you that credit should be given to the effort that has been made over the past few years, and again, in the spirit of bipartisanship. I think some of that credit, by the way, goes back to the latter years of the Bush Administration as well, even though the cyclical effects of that got washed out. But we have made progress. The budget deficit, in round numbers is something like 2½ percent of GDP now. It was 6½ in the mid-1980's.

Now having said that, I think there are 3 points to keep in mind.

First, independent of what is or is not done with health care, I think most observers expect that as we get out roughly to the end of the decade and century, but certainly as we get into the early part of the next decade and century, as things stand right now, the budget deficit, then a so-called baseline is going to start to get worse and get worse fast.

Second, analytically, the right way and, indeed, the only way, to look at the budget deficit is not relative to GDP, but it's relative to domestic savings. This is the Achilles heel.

I haven't done the arithmetic lately. Felix, maybe you have. But I would be astonished, even with the improvements cited earlier, if it were not still true that financing the budget deficit is consuming at least 50 percent of our total private savings. But more than that, the spill-through effects of the budget deficit into the international side of the equation, which roughly can be thought of in terms of our current account deficit, which again is $130 billion or so, what we're doing as a Nation is effectively financing ourselves, filling our domestic savings gap by importing savings from the rest of the world.

Now you—not you. I apologize.

One may say, well, gee, it's not all that big. The current account deficit is, what, 1¾ths percent of GDP.

Well, it is big, because our GDP, as Leo was suggesting a moment ago, is still 25 or 28 percent of the world. So if you put our situation in the context of what we're doing relative to our own savings, and the extent to which we are absorbing so much of the rest of the world's savings, it's just an untenable situation.

The last point and, again, it's the one that everyone has made, no matter what you think of the numbers, the world is not standing still.

And again, our challenge as a Nation, not only in the context of our economics, but in terms of our ability to continue to provide genuine leadership around the world, is in jeopardy if our approach to the rest of the world ends up as hat-in-hand, in a context, again, in which the rest of the world is not standing still.

So that's the best I can do, Mr. Chairman, to try to size it for you. But the key point is it's not simply a matter of numbers. And it certainly is not numbers of budget relative to GDP.

Mr. ROHATYN. Mr. Chairman, let me add onto that from, again, the perspective of the value of the dollar.

Over the last 5 or 10 years, we have had big budget deficits. We financed a good part of those by inflows of foreign capital. We had strong Japanese participation in our Treasury financings and we had relatively low outflows of American capital to emerging markets.

As the dollar weakened, that all shifted and there was lower participation on the part of foreign capital in our Treasury financings and a greater capital outflow in terms of our investment abroad.

If you combine that, what it means is that there is a greater and greater amount of domestic savings used to finance our deficit, even though our deficit is coming down.

Now if you look ahead 4, 5, or 6 years, you see that this refunding of the Federal debt, which is, I think, around $2 trillion over the next 4 or 5 years, you add that onto the additional deficit and factor in what happens if, in order to attract foreign capital to participate here, we have to raise interest rates 1 percentage point on $3 trillion of refunding or refinancing.

Those are huge amounts of interest payments that will be added to the Federal budget without any assurance that there will be an end to the process as you keep devaluing the dollar.

So even though we have made progress on the deficit, I believe that it is very important to strengthen the dollar in order to do these financings without increased interest cost as much as possible, and to reduce the borrowing requirements of the Government by reducing the deficit so that we're not prisoners to foreign capital or forced to use up 100 percent of our savings, or 70 percent of our savings to this financing.

The CHAIRMAN. Are those refinancings that you cite over the next 5 years, and you would know, too, Mr. Corrigan, does that represent an anomaly? Is there an unusual sizing up of the amount of roll-over that is going to hit within that time period that somewhere in the past, there was the timing of the issuance of securities that create a sharper than normal ramp-up in refinancings? Or is that par for the course?

Mr. ROHATYN. I believe that there was a policy to shorten some of the debt in order to produce budgetary savings over the last few years. And when you superimpose that on $3 trillion of financing that was done over the period, 1980 to 1994, you have the normal refundings of those bonds, plus the shortening of the debt that was done as a way of reducing budgetary costs.

The CHAIRMAN. From your knowledge, off the top of your head, do we have an abnormality built into that refinancing schedule in the next 5 years?

Mr. CORRIGAN. No, not in any significant way. I think the most important anomaly, but it's no longer an anomaly, is that because of the tremendous build-up in stock of Treasury debt owned by foreigners, there is a much larger share of that total that has to be refinanced that is in the hands of foreigners.

I think that's far more important, Felix, than even the modest effect of the change in debt management policy that we saw about a year and a half ago.

The CHAIRMAN. But, anyway, we have this double-barrel effect going. We've not only got to have foreigners decide to keep their investments in new refinanced Treasury obligations, but we're seeing this pattern of more and more American capital going out around the world as the world opens up and as we have these new opportunities in the part of the world that was closed off for investment.

Now, as Leo says, pretty much every country of consequence has now gone to a market system in the form of capitalism, and so capital is flowing in those directions. We're going to have to compete even harder for the American investment dollar as apart from the Japanese investment dollar.

So it seems that if these capital needs are burgeoning because you have the part of the world that was behind the wall now out and privatizing, the competition for savings—if you're going to be a dissaver yourself, your own internal economy, going out and getting the margin that's paid for your standard of living and you've become accustomed to, I can see that becoming a real problem. And that may be part of even what we're seeing now.

We're seeing upward pressure on interest rates with all the speculation as to how much inherent inflation there may be in the gold prices and a lot of other things. But as I saw the uptick just in long Treasuries yesterday, probably in part due to the fact that the Fed didn't act. We're pressing up against eight on the long bond yield and who knows where that's going?

Mr. ROHATYN. On this point on the private capital markets, Mr. Chairman, I think it's also worth pointing out that if there is an expectation of a weaker dollar, it puts more pressure on American money managers to invest abroad because they'll benefit, both from the devaluation of the dollar and whatever improvement they see in these other markets.

The CHAIRMAN. Leo, you didn't get a chance to comment.

Mr. MELAMED. Well, there isn't much more that I could add to that, except to say that the budget deficit is a relative issue. In actual numbers, the deficit maybe lower. But relatively speaking, as the United States now competes with market economies around the globe, it isn't a small number. In fact, it's a fairly large number. The real question is: How does the world view the U.S. dollar?

Felix Rohatyn has made the point time and again, as I would, that our dollar is weak simply because the world views us to be financially in a difficult spot and the reason is the budget deficit.

If there is a cure to the weak dollar—and it's not an easy one—it has to do with the budget deficit.

The CHAIRMAN. I want to come back to that.

Senator Moseley-Braun.

Senator MOSELEY-BRAUN. I serve as a Member on the Kerrey-Danforth Commission on Entitlements and Tax Reform. And I have to report, it's been real regrettable, but in the last several weeks, the controversy on that Commission has gotten to be more and more pointed, the voices more and more shrill, in large part because those people who represent interests of poor people, working people, postal workers, retirees, and the like, have made the point—I think they're making it very well—that we're the only ones being asked to come to the table.

When you talk about entitlements, all you want to talk about is transfer payments, all you want to talk about is payment for my pension, my retirement and the like, and don't take away from me something that I thought I was promised.

In any event, where are the rich people in terms of the discussion of the tax expenditure side of the equation, the tax structure side of the equation?

I think that point is well taken and I'm hopeful that the Commission can address and can achieve some kind of balance because if we just talk about entitlements in terms of transfer payments and not talk about entitlements in terms of tax expenditures, what we will do is create an imbalance that will doom the work of the Commission and I think that would be a real tragedy and would be regrettable.

I hope that we can have some discussion about what we need to do on the tax side, what we need to do in order to make certain that we attack the budget deficit through having more equity in our tax structure. Not that I'm advocating raising higher taxes. If anything, that's the bete noir of any politician. You just don't want to talk about higher taxes. But the fact is, on the tax expenditure side, there's an awful lot of money that's kind of hemorrhaging out and be siphoned out that's not being captured, that's not going into savings, that's not going into investment, and that's leaving us not only with the deficit situation that we face, but also with the perception problem that you speak about, Mr. Melamed.

Mr. Corrigan, you spoke specifically about the Entitlement Commission. Could you all respond to what directions you think we ought to take in terms of addressing tax structure and tax expenditures as part of this effort to reduce the deficit?

Mr. CORRIGAN. I think Mr. Rohatyn was the one that actually spoke about the Commission. Felix is a lot closer to the tax structure questions than I am.

The one observation I would make, Senator, is when we ask ourselves the question, what's really going to make a difference over time in terms of our ability as a Nation to compete, mind you, I'm sure we'll be there. I really am.

I think in a very simplified way, the question can be put in somewhat different terms. And that is, what policies, what approaches are the approaches that are likely to work in the direction of increasing the trend rate of growth for the productivity of the economy as a whole?

There's absolutely no question that that's the lifeblood of the system. Indeed, when you look at the differences, say, between the performance of the U.S. economy roughly today and you go back, Felix, to the period, say, 1955 to 1965, which was probably as close to nirvana as you'll ever get, and you do a scorecard, what's different?

The most important thing that's different is productivity. In those days, we took as an act of faith that productivity was going to go at 3 percent a year and it did. Today, we sweat out 1½ percent. So what kinds of policies, recognizing that this isn't going to happen overnight, can get us back into the major leagues in productivity terms?

We've done it in the industrial sector, but we haven't in the rest of the economy. And the simple answer, of course, is investment, including, and perhaps especially, investment in human capital. I think that's the part we often forget. It's not just factories and bricks and mortar and computers, but it's human capital as well.

So I'm not nearly sophisticated enough, Senator, perhaps Felix can help you more than I, to give you the bill of particulars. But that's how I'd frame the issue.

Mr. ROHATYN. Senator, on your question, I served a few years ago on a national economic commission that was appointed by, I think, President Reagan. It was a bipartisan commission and Senator Domenici was also a member. Lane Kirkland was, Bob Strauss was—we had a very interesting 12 people. We were looking at taxes. We were looking at entitlements. We were looking at defense.

We had actually come out with an approach that I think would have probably worked. And because of the fact that we were touching on some of these issues, President Bush, who was just coming into office, refused to have anything to do with it and the commission died, which I think, in retrospect, might have saved his Presidency because we would have made a huge difference to the economy.

So I don't disagree with you. I think all these things have to be looked at. I personally have never felt that there is any great need to lower capital gains taxes because I don't think that makes any difference at all. I think lowering the cost of capital and increasing productivity is a much more important issue and there are other taxes that are much more harmful to the economy and some others that ought to be increased because they'd be more beneficial.

But I join Gerry, I think in many ways human capital is as important as fixed capital. I think our entire tax system is totally screwed up and I think Senator Domenici and Senator Nunn are trying to do something overall about it. That's probably a long time coming but I certainly think that all of these things should be looked at if you're looking at a fair and equitable solution to this problem.

Senator MOSELEY-BRAUN. Well, certainly, if anything, our conversations previously, Mr. Rohatyn, have been about human capital and the value of education. We share a passion for education reform. And certainly, that is the kind of direct investment in human capital that needs to happen in order to give us the capacity to get these productivity gains of which you speak, Mr. Corrigan.

But getting to the specifics of the tax question, I don't know if your commission had issued a report or not——

Mr. ROHATYN. No, it never did.

Senator MOSELEY-BRAUN. Never issued a report.

Mr. ROHATYN. We were asked not to.

[Laughter.]

Senator MOSELEY-BRAUN. Because I must say, to the extent that you might want to write a letter or make some suggestions to the Entitlements Commission, I think it would be very helpful.

I tend to be optimistic about these things. I'm getting more and more worried that the Entitlements Commission is going to go the way of those commissions for which they just can't get past the

brick wall because the voices are getting more and more shrill, the controversy more and more pointed, and it looks as though the Commission is just kind of going in circles right now.

It seems to me that the way out of the circle is to try to suggest an approach that will give balance to the deliberations of the Commission, balance so that both the tax side, where wealthy people can make a contribution, gets put on the table as much as the transfer payment side gets put on the table. And I think if we can achieve that kind of balance, we'll go a long way to at least addressing this question because it crops up all the time.

We voted on the Department of Interior Bill just this morning, with Senator Byrd talking about how discretionary spending is getting less and less and more and more difficult to do because of these entitlements and mandatory payments out of the budget.

So we have some real structural issues on this end in terms of Government that really impact very directly on what happens in the private sector. We would appreciate whatever contribution you can make in that regard.

Leo—I mean Mr. Melamed—did you have something you wanted to say?

Mr. MELAMED. Senator Kerrey said that entitlements are the third rail of politics. I think they are the third rail of a lot of things. Unfortunately, they are so very difficult to touch, and yet, they are something that need to be addressed.

Entitlements impact investment in human capital, as you suggest. I subscribe to that as well. It is an issue that needs to be addressed and fixed.

Felix just stated that the tax system is unwieldy. I believe it is and that it requires a major overall. There will be some pain involved in doing that. Somewhere down the line, we're all going to have to do that.

Other than that allow me to say that I'm very pleased to find the Senator from my own home State sitting on this Committee and asking me questions.

The CHAIRMAN. If I may, I made the decision as we were finishing, we finished a very busy legislative year in this Committee and a busy 6 legislative years as I've been Chairman. But I wanted to finish with four hearings, of which this is one, one looking at how the American financial system is doing and what are the trendlines we're riding and how do you put it in the context of this rapid globalization situation that we've all been talking about.

We had over 40 hearings here over the last 6 years on U.S. competitiveness, where we've brought in people, some of you, as a matter of fact, but others across the spectrum to look at that. And so we've had a wrap-up hearing on that issue and where we're going. In fact, we now have built into the law the requirement that the Commerce Department actually prepare a comprehensive statement in that area and there would be a strategy embedded in it. Ron Brown was here the other day to present that.

We've also had a final hearing on the strength and stability of the American banking system because we've had so much buffeting out there over a period of time. The last one we're going to look at still ahead of us has to do with how we're doing in the international trading system because we've also through this Committee

compelled a rationalization of the various parts of the Government that are into trade promotion and put them all into one coordinating operation. And so there's a much different kind of an emphasis on trying to go out and, at least, do a better job of selling what it is that we have to sell around the world.

I don't suggest that that covers the whole waterfront, but it covers most of the waterfront with respect to the jurisdiction of this Committee. But what I'm struck by in listening to this today, because this is really illuminating, I think, way beyond what anybody may understand right now because of the power of the observations you're making. And that is that our situation is changing dramatically because nothing's standing still. You've got all these dimensional changes happening.

So, in a sense, the drop in the budget deficit, while we're happy to have it, may give us a false sense of security because there are other things that are washing the ground out from under us that, in a sense, may in fact have more than offset that, just in basic economic effect.

For example, if we have a situation where because of the changes in the world capital demands are ramping up quite sharply, and investment patterns are such that the investment dollars of Americans are increasingly seeking market opportunities outside this country, if we've become accustomed to sort of riding the savings of other countries and financing our huge debt requirements, Government debt requirements, you can get yourself into a false—you can get into a cocoon in the sense of security that if you just tinker around on the margins here and you get some of your trendlines improving, that you'll work your way through it, when in fact, you may have other bigger dimensional changes happening that are really undercutting your premise of a year ago or 5 years ago or 8 years ago.

So that you've now got to go back and reconstruct your equation because you have different elements coming in different ways and the net of it all at the bottom may be quite different. You have to adjust your policy path or you're going to find yourself in real difficulty at some point here.

I could see, for example, if I just try to go off what you've already said, I could see how you could get an upward spike in interest rates that could really be very unsettling simply from some of these elements that are already loose and in the puzzle.

People don't want to take our debt in sufficient amount if opportunities look more attractive other places. If the fear of budget deficits going up again 4 or 5 years from now sort of play back into today's market expectations, if the dollar stays weak or gets weaker, you wouldn't even have to have a market accident to create real problems for yourself. You can have a mix of factors that will create real problems that can suddenly overtake you, even though you think you've been making progress.

I'm feeling that as we have this conversation that the ground is moving out from under my feet as a policy analyst or as a policymaker here, at least in part, for the reasons that you've all been citing one way or the other. One of the great ironies of it is that, in a sense, when so much of the world was locked up behind an Iron Curtain and were starved in terms of their development op-

portunities, in some sense, I mean they couldn't get Western capital to speak of.

Once we get that fortunate change in circumstance where everybody's now into capitalism, then you'd better be a pretty effective capitalist yourself in terms of how you manage your affairs or you're going to find that you can be the leading capitalist and running back in the pack there behind other people. Not just in terms of market structures, in terms of innovation and the ability to maintain an efficient market that inspires confidence and attracts investment dollars and recycles them out to the various investment uses.

But it seems to me we are now in a situation where some of the imbalances that we have had that we could tolerate under previous conditions, we may not be able to tolerate the same way under these changing conditions, and that this trendline mix that we're riding here may be much more threatening to us than we now perceive. In other words, old habits really do need to change dramatically here or we're going to get caught short.

I also worry about the degree to which just the speed of change and this interconnectedness in the world can create situations where unforeseen events and innovations can trap too many people off base at one time until we figure out how the game works.

We've seen that, some of that, in the derivatives area right now. Now whether you can see enough of it at one time combined with something else to really give you a cardiac arrest in the system, I don't know anybody smart enough to tell me one way or the other on that. I don't know people smart enough to try to answer that question than the three of you sitting there. But my sense is that we don't know the answer to that because we can't necessarily foresee what kind of mix of factors might occur at some particular time that could be outside the bounds of what would settle itself out in an orderly way.

I remember back in the days when we had portfolio insurance and that was a hot item and everybody thought that was working and so forth and so on. Then all of a sudden it disappeared, like a unicorn, but not before some people were disappointed in the fact that when everybody wanted to get on the elevator at one time, there wasn't enough room. So people got left on floors where they didn't want to be, as values changed rapidly.

But I must say, just based on what you've said thus far, and you've all said it in different ways, but it all, it seems to me, connects into something of an important whole. And that is that this is a very risky time for us in terms of our strategy decisions and our internal economic adjustment process, and that we've got to do some things in terms of reasoning our way through how we integrate ourselves into this changed world situation.

Market mechanisms is just one piece of it, but the larger economic strategy issues, investment and savings aspects of this, the degree to which we can run our system efficiently with high productivity and good investment, inspire confidence, keep the dollar high, is probably what we ought to be talking about right now. We're not really talking about that. As I listen—I don't happen to be running this year, for the first time in 28 years. But as I listen

to the debate filter back in from around the country, I don't detect too much discussion on these issues.

In other words, I'm not sure this is where the debate, to any meaningful degree, is focused, partly because this is a pretty esoteric subject, and this is new. We've kind of been catapaulted, I think, or hurled into a new set of realities here that we really need to understand more fully. I think your statements today help us get a lot closer to that kind of an understanding.

But I'm not sure how we get it if we don't collect people like yourselves who are out there doing this. I mean, you're out there right now in the old Soviet Union, Russia and South Africa, I know trying to help them make this market system conversion.

All of you are involved in different ways in trying to work through these international changes. I'm very struck by this. I'll make a final comment in a minute. I know you have to leave in a moment, so let me call on you for any other questions or observations you'd care to make.

Senator MOSELEY-BRAUN. Thank you, Mr. Chairman. I just simply want to thank the witnesses and I certainly look forward to continuing this conversation with you.

The Chairman is exactly right. There needs to be more discussion of these issues in this way, so that we can begin to create a climate of opinion out there in the larger community that will allow for sensible policymaking here.

One of the things about any legislative body is that it is as much reactive as anything else. It reacts in large part to the sense of what the people want and what the opinions are out there.

I think that this kind of sensitive, sensible dialog about future trends, about the direction in which we're heading, about the fundamental structural and systemic changes that we're undergoing at this time in our history, is critically important because right now everybody's groping and looking for the right path and the right answers.

If these voices are not heard, and again, that's one of the reasons, Mr. Chairman, I'm so grateful that you convened this meeting with this panel, because if these voices are not heard as part of the dialog, then the decisions that get made will be made in response to other voices.

I again want to compliment and thank the members of this panel. I do have to leave. I have an appointment that I'm going to have to dash to. Thank you for adding your voices to the debate. It's going to make a big difference in the kinds of decisions that can be made and in the level and the kind of discussion that will take place as part of the decisionmaking process.

Thank you.

The CHAIRMAN. Thank you. Would it be fair to conclude, and I'm going to ask each of you to react to this, that the budget deficit now—let's say it's in the $200 billion range—is it conceivable that a $200 billion deficit now in the context of these changing trendlines on a global basis, could actually be more damaging or threatening to the future than a $250 billion deficit was, or $270 billion deficit was, 3 years ago?

I realize it's part of the same continuum of difficulty. But if you change the trendline mix and the element of key factors, is it con-

ceivable that even a smaller deficit, in a sense, could be even more dangerous if not understood for what its real impact might be in the face of more adverse surrounding circumstances? Is that going too far?

Mr. CORRIGAN. The answer, I think, is absolutely yes. It not only can be, but, in my judgment, is.

The CHAIRMAN. More threatening.

Mr. CORRIGAN. Yes. And again, if I could just make one point to reinforce what I think we've been trying to say, Mr. Chairman.

If you use that benchmark say of 3 years ago, and not lose sight of the fact that not only in the United States, but throughout the entire industrial world, private capital demands were very subdued because most everybody was either in or close to recession.

The CHAIRMAN. That's true, too. You had a cyclical factor built in.

Mr. CORRIGAN. Sure. So if you superimpose that cyclical reality on the stuff we've been talking about, frankly, I don't mean any disrespect with this, it's a no-brainer. It is more dangerous.

Mr. ROHATYN. But it's also not recognized.

The CHAIRMAN. But that's why we're here. Because if it is more dangerous, and it is as important as you all seem to think it is, and I agree with that, in terms of just the logic in my own mind, then this is what we'd better talk about. We'd better change the focus of the discussion so that we get around to this so that we start to understand the dimensions of the risk that we're running. We're talking about risk in derivatives. There's more than a little risk in this policy arena if we misjudge our circumstance.

If the golden age in America after World War II, and maybe coming up in the mid-1960's before we really got deeply involved in the spending on Vietnam and so forth, I don't want us living with the illusions that somehow or other, all of this is self-correcting, that if we just, in a sense, do a little bit of tinkering here and there and hold our breath and figure that things will work out fine and dandy—it sounds to me like what you all are saying is that that would be a big mistake to assume, that we have not put in motion the combination of policy elements and internal performance yields that, in effect, are going to let us beat the train to the crossroad.

In fact, you're saying, as I hear it—you're not being an alarmist, but you're saying, put us in the context of this changed world and our old ways are not going to do it for us. There's like a clock ticking and you'd better understand it as a policymaker because if you don't, we're going to find ourselves in a situation here where we might not have the same latitude to work our way out of these problems that we've counted on having in the past.

Mr. MELAMED. Mr. Chairman, you're precisely correct. In the last 5 years the world changed so dramatically and the relative nature of deficits also dramatically changed. The capital demands around the world are so different now than they were just 5 years ago, and certainly 10 years ago. As a result, the nirvana of the 1950's and 1960's is gone forever.

I fully agree with Gerry Corrigan. We're going to be there. We're going to find the way. But we do have to refocus on that reality. The world is different. We can't just look on the absolute number of the deficit. Sure, the number has shrunk—and we're all relieved

that it has—but it's entirely different now. In a relative way, the budget deficit is much more serious for us than it ever was before.

Mr. ROHATYN. I'd put it this way, Mr. Chairman. I think today, the world's capital markets are the engine of who develops and who doesn't, as opposed to the World Bank and the IMF 10 or 15 years ago. And they are a totally ruthless, Darwinian kind of judge. They will judge us on an equal level with India, China, whatever.

The CHAIRMAN. You mean the investment dollar has no conscience in that regard, beyond returns.

Mr. ROHATYN. An investment dollar certainly has no conscience. It has greed and fear. Those are the two things that I think you have to look at.

Mr. MELAMED. Let me read into the record a succinct statement made by Milton Friedman the other day, that "the current revolution has made it possible for a company located anywhere in the world, to use resources located anywhere in the world, to produce a product anywhere in the world, to be sold anywhere in the world." That's the world of today, and it's quite different than ever before.

The CHAIRMAN. Did you have a final comment, Mr. Corrigan, before we finish here?

Mr. CORRIGAN. I did want to say something, if I could, very briefly, Mr. Chairman.

I think it's very, very important that you and others have this perspective that we've shared with you. But let me just emphasize something else, even, Felix, in the context of the dollar.

As a former Fed official, I still don't make pronouncement on spot interest rates and exchange rates. But I do want to make one very important point.

I could make, I think, a pretty good intellectual argument that even right now, as we sit here, the dollar may be artificially undervalued because I think that we all may have lost sight of the tremendous improvements that have taken place and the underlying competitiveness of the U.S. economy, with particular emphasis on the manufacturing sector.

The problems that we're talking about are very real. They stretch out over a period of time. But we should not lose sight of the fact that we've come a very, very, very long way in restructuring. We're far, far ahead of the rest of the industrial world in restructuring of industry and, indeed, even our keenest competitors are playing real catch-up ball with us today.

Again, I think that the perspective of time is needed. The issues are real. But it's not as if we're standing still, either.

The CHAIRMAN. Yes. Well, that example I cited earlier of that strike in my hometown of Flint where the workers who are being very productive, but who are working 6 days a week and are bone-tired. Or the example I just read about where Warren Buffett decided to invest in a shoe company, Dexter Shoe Company, because he decided that he could make shoes in Maine better and cheaper and more competitively than you could make them anywhere else in the world.

So it's kind of nice to think of it running the gamut from cars and trucks, on the one hand, to shoewear on the other hand.

We have made great gains in productivity and that's the happy part of the story. But I don't think that alone is going to get this job done. I think we are in a race now. We're in a time race that's different and it's changed and I don't think we comprehend it yet.

We think of the end of the Cold War as a wonderful blessing as it is, but it creates a new kind of challenge that, in a sense, is far more difficult for us because it forces us to take the scales off our eyes and really think anew.

That debate, which I think probably we're helping to advance here today in this setting, that's the debate we have to have. Now we have to move ourselves up to where reality is and where the events are taking us, or we're going to have a very unhappy country here because we have a lot of problems to solve.

The under class is still growing. The middle class is still being squeezed. And so, we can't afford to misfire here. We need some adjustments and some strategy.

Thank you. I know you have to run for planes. We're most appreciative.

The Committee stands in recess.

[Whereupon, at 1:05 p.m., the Committee was recessed.]

[Prepared statements supplied for the record follow.]

PREPARED STATEMENT OF SENATOR ALFONSE M. D'AMATO

Mr. Chairman, I join you in welcoming today's panel of distinguished witnesses. Before we turn to the subject matter of today's hearing, however, I would like to commend and congratulate you for your excellent leadership of this Committee over the last 6 years.

At last week's hearing, my colleague from North Carolina thought you might be feeling like a pancake from all the syrup poured over you recently. But I'm not here to butter you up today with false praise.

The truth is, Mr. Chairman, your leadership has been anything but flat. With your able guidance, this Committee has risen to the serious challenges posed to the financial services system.

This Committee has responded decisively to the crises in our thrift and banking industries by developing and passing FIRREA in 1989 and FIDICIA in 1991. Again, under your leadership, the Committee has also made banks more competitive globally by finally breaking down barriers to banking across State lines with the recently passed Interstate Banking and Branching Act.

You helped make the promise of economic development a reality through passage of the Community Development Financial Institutions Bill. In this bill, you have also helped expand financing opportunities for small businesses by helping me pass my Small Business Loan Securitization Bill. This bill also improves the competitiveness of financial institutions by removing unnecessary and burdensome regulatory requirements.

The Committee has also made sure that the U.S. capital markets have maintained their reputation for integrity. In 1990, this Committee passed legislation giving the SEC additional authority to impose discipline on the markets with the Market Reform Act and the Penny Stock Reform Act. In 1992, the Committee opened up the Government securities markets by enhancing disclosure and increasing the transparency of this critical market.

Of course, you had help passing these bills from the Members of this Committee, including the Chairman and Ranking Member of the Securities Subcommittee. It was your leadership skills as well as your role as a mediator and consensus builder that enabled this Committee to work together to develop and pass this legislation.

Your foresight and proactiveness was reflected in the number of hearings this Committee conducted over the last 6 years. In fact, during the last two Congress; that number adds up to 278. Although Committee Members—myself included—have grumbled over the sometimes overwhelming numbers of hearings this Committee convened, I have commended the Chairman for each and every one of them.

Mr. Chairman, let me assure you it is better to feel like a pancake than a hotcake.

I commend you for your leadership and insight. Thank you and I wish you and your family a happy and prosperous future.

PREPARED STATEMENT OF SENATOR RICHARD C. SHELBY

I would like to briefly welcome the distinguished panel we have before us today.

Chairman Levitt, I understand you testified yesterday before the House Subcommittee on Telecommunications and Finance. We certainly appreciate you joining us here today to discuss what, I believe, are very important developments in the United States and international financial marketplace.

As Chairman Greenspan noted in last week's hearing, and as all of you emphasize in your written testimony today—how regulators and policymakers respond to dynamic market changes—changes that are being spurred by technological and telecommunications growth—is critical to our future competitiveness in an increasingly integrated, international financial market.

Your attendance and comments today, I hope, will help lay the groundwork for some of the new and complex issues this Committee will need to address in the next Congress.

Again, welcome.

PREPARED STATEMENT OF SENATOR CAROL MOSELEY-BRAUN

Mr. Chairman, at the outset, I want to commend you for holding this hearing. This is a very appropriate time to be reviewing the condition of U.S. Capital Markets, and the Internationalization of World Capital Markets. Our financial system is not in crisis, it is healthier than it has been for many years. This is a good time,

therefore, to take a look at the long-term trends, and to consider whether any policy changes are needed to ensure the future systemic safety of the financial system, and to ensure that the evolving system is able to meet the financial needs of all Americans and the American economy during this time of rapid, fundamental change.

We have a distinguished group of witnesses before the Committee this morning, and I look forward to hearing their testimony. I want to take particular note of a constituent of mine, Mr. Leo Melamed, the Chairman and Chief Executive Officer of Sakura Dellsher, Inc. and the Chairman Emeritus of the Chicago Mercantile Exchange. Mr. Melamed is uniquely qualified to talk about the increasing globalization of capital markets, and the changes in capital markets generally, because he has played an instrumental role in developing some of those changes. Leo is truly a Renaissance man, and I know the Committee will benefit from his thinking on these important issues.

We hear a lot these days about the globalization of capital markets, and there is no question that the pace of change in these markets is very rapid. There are new products, new competitors, whole new financial markets, and entirely new methods of delivering financial services that did not exist very many years ago. We could not bring back the simpler, slower past if we wanted to, and I don't think we should want to, since it is beyond dispute the United States has benefited greatly from these changes. The changes also present many challenges for us as policymakers, however. The new global environment is much more complex, and it moves much faster. We need to understand the new risk environment, and to be sure that we have the tools in place to cope with any systemic problems that might arise. We need to know whether our legal and regulatory systems need to be changed to meet the new challenges our new and continuously evolving capital markets present. And we need to be sure that some Americans are not frozen out of the new system—that they do not lose their access to financial services that are critically important to them, and to their communities.

I am pleased, Mr. Chairman, that, under your leadership, the Committee is considering these issues that are so important to our future. I also again want to thank you for your help in ensuring that the comprehensive financial services study legislation that I authored will now become law. That study will, I believe, help this Committee greatly as we face the challenges our evolving financial future presents.

PREPARED STATEMENT OF ARTHUR LEVITT

Chairman, U.S. Securities and Exchange Commission

Concerning International Markets and Individual Investors

September 28, 1994

Chairman Riegle and Members of the Committee: I appreciate this opportunity to testify, on behalf of the Commission, regarding the international securities markets, the Commission's efforts to improve international regulatory cooperation and standards, and the Commission's efforts to protect individual investors.

The international issues facing the Commission and the interests of individual investors are related in several ways. To maintain the international competitive position of the U.S. securities markets, the Commission must above all maintain the confidence of individual investors in these markets. To serve the interests of these individual investors, the Commission must attract foreign issuers to the regulated U.S. markets, and must strengthen international regulatory standards and cooperation. Just as no man is an island, no investor today is only a domestic investor. We are all, whether we like it or not, affected by developments in the international securities markets.

I. The U.S. Securities Markets are World Leaders

Worldwide political and economic conditions have changed dramatically in the past 10 years. The collapse of communism in the former Soviet Union and Central Europe, and the economic reforms in China, Latin America, and elsewhere, have created whole new commercial and financial markets. The established financial markets are changing almost as rapidly as the emerging markets, with new investors, new instruments, and new strategies.

The securities markets of the United States and other nations have, over the past 10 years, experienced significant growth in capitalization, participation, and transaction volume. Interaction among all the international markets and market participants has increased: Companies are increasingly using foreign securities markets to

satisfy their needs for capital, and investors increasingly look abroad for diversification.

Through all this growth and change, the U.S. capital markets have retained their pre-eminent position. The U.S. securities industry continues to be the world leader in terms of strength and sophistication; the U.S. capital markets offer customers around the world the opportunity to participate in the most liquid, innovative, efficient, and fair markets in the world.

Capitalization and trading volume of the U.S. equity markets consistently exceed those of other major markets. At the end of 1993, U.S. equity market capitalization was about $5.2 trillion. This was more than the equity capitalization of Japan ($3.0 trillion), the United Kingdom ($1.15 trillion), Germany ($463 billion), and France ($457 billion) *combined.*

Trading volume in the U.S. equity markets has increased, over the last 5 years, from about $2.2 trillion in 1989 to about $4.0 trillion in 1993. In Japan, trading volume declined sharply over the same period, from about $3.0 trillion in 1989 to $782 billion in 1993. Although U.K. trading volume increased from about $463 billion in 1989 to about $866 billion in 1993, it remains less than a quarter of the equity trading volume in the United States.

The most important measure of a securities market, perhaps, is not its capitalization and trading volume, but its ability to raise capital for companies, and thus to create jobs and support new industries. The U.S. markets succeeded spectacularly in raising capital in recent years. In 1992, over $950 billion was raised through securities offerings in the United States. In 1993, the figure was more than $1 trillion. By way of comparison, in 1992, only about $75 billion was raised through securities offerings in Japan.

The U.S. equity markets have attracted an increasing number and variety of investors in recent years. One of the significant global trends of the past 20 years has been the growth of institutional investors, such as mutual funds, pension plans, and insurance companies. Between 1975 and 1993, the share of the U.S. equity market owned through mutual funds more than doubled, from about 4 percent in 1975 to about 10.9 percent in 1993. During the same period, the value of U.S. equity securities owned by private and public pension plans increased by more than a factor of ten, from $132 billion to $1.6 trillion. The present equity holdings of *one* of the largest public pension plans are almost equal to the amount that was held by *all* the public pension plans in 1975.

It is important to remember, however, that all these institutional investors, in one way or another, are investing on behalf of individual investors. Moreover, U.S. individuals continue to be significant *direct* participants in the U.S. equity markets. Over the last 5 years, individuals in the United States have continued to account for about 49 percent of total U.S. equity holdings. In comparison, retail investors account for only about 20 percent of overall equity ownership in the U.K. markets today and only about 24 percent of overall equity ownership in the Japanese markets.

The extent to which individuals rely on the global securities markets is likely to increase as more people become responsible for managing their own retirement assets. Employers are shifting from defined benefit plans to defined contribution plans, and employees within these plans, often select mutual funds or individual stocks as their investment options. The investment decisions that employees make regarding these assets will have major implications for their own lives, and indeed for the Nation, so that full disclosure and investor education are more important than ever.

The U.S. equity markets have also attracted, in recent years, increasing investment from overseas. The gross value of foreign trading in U.S. stocks has increased from about $416 billion in 1989 to over $617 billion in 1993. In 1993 alone, the *net* purchases by foreign investors of U.S. equities reached a record of $21.5 billion.

U.S. investors have been similarly, indeed more dramatically, increasing their investments in foreign securities. The gross value of U.S. trading in foreign stocks has increased from only about $30.4 billion in 1984 to more than $559 billion in 1993. In 1993, the net purchases by U.S. investors of foreign equities increased to $67 billion, more than twice the $32 billion of net purchases in 1992.

The world's securities markets today are both separate and related. The markets are still separate; domestic political or economic events may have serious implications for one securities market and no noticeable effect on other markets. Thus, price movements in one market will not necessarily lead to price movements in another market. On the other hand, the markets are related in many important ways: Issuers looking for capital consider not only their domestic but also overseas markets; investors similarly look overseas for opportunity and diversification; and the major institutional investors are increasingly active in all the major markets. The

increased interrelation of the markets makes international issues ever more important for the Commission and for U.S. investors.

Transparency is a critical means of protecting investors and improving efficiency, especially as trading becomes more dispersed among global markets. Transparency gives all investors in the U.S. markets comprehensive, comparable, and consistent market information. This serves the related goal of enhancing market liquidity and depth by creating investor confidence, so that investors will view the securities markets as an attractive investment.

The Commission is committed to preserving the leading position of U.S. securities markets. We can achieve this by continuing our efforts to protect investors by maintaining competitive, fair, and efficient markets. Although the debate sometimes is phrased as though investor protection and efficient markets are contradictory goals they are in fact inseparable. Maintaining the fairness of our markets is a means of enhancing our global competitiveness.

II. Attracting Foreign Issuers and Strengthening International Standards and Cooperation

A. ATTRACTING FOREIGN ISSUERS

As noted above, American investors are increasingly purchasing the securities of foreign companies. Foreign companies are, correspondingly, increasingly interested in having their securities traded or listed in the United States. The Commission, for its part, is strongly interested in seeing these sales and purchases occur in the regulated U.S. markets, so that U.S. investors receive appropriate information and protection, and so that the U.S. markets retain their leading position. The strong disclosure and investor protection framework of the regulated U.S. markets is what makes them so attractive to foreign issuers and to all investors.

I have made attracting foreign issuers to the regulated U.S. markets one of my personal priorities as Commission Chairman. I have consistently stated that the Commission is eager to work with foreign issuers to ease their transition into the U.S. regulatory system—without compromising the essential elements of that system that protect U.S. investors. I have discussed with foreign issuers and their advisers in several countries including China, Germany, Mexico, and Switzerland, the advantages of the regulated United States markets. Just last week, I had a useful meeting in Germany with United States financial analysts and German issuers to discuss the differences between United States and German disclosure and accounting practices.

The Commission as a body has acted in the past year to streamline the reporting and reconciliation requirements applicable to foreign private issuers. The Commission has amended its rules so that more foreign issuers are eligible to use short-form prospectuses and shelf registration. The Commission has also amended its reconciliation rules to allow:

- Offering document financial statements that are updated principally on a semi-annual, rather than quarterly, basis;
- First-time foreign registrants to reconcile the required financial statements and selected financial data for only the two most recently completed fiscal years and any interim periods;
- Use without reconciliation of cash flow statements prepared in accordance with International Accounting Standard 7, as amended;
- Reconciliation of separate financial statements of equity investees and acquired businesses only if they exceed the significance level of 30 percent;
- Acceptance of a simpler form of reconciliation for all offerings of investment, grade debt, or preferred securities; and
- Accounting accommodations for foreign companies that use pro rata consolidation to account for an investment in a joint venture.

The Commission has also proposed to further streamline reconciliation requirements in such areas as reporting currency, business combinations, and operations in hyper-inflationary markets.

Our efforts in attracting foreign issuers have been quite successful. As shown in the chart at the end of this testimony, in contrast to the trend in other major public securities markets around the world, the U.S. public markets are attracting a steadily increasing number of foreign companies. Since January 1, 1993, 191 foreign companies from 26 countries have entered the United States reporting system including companies from Argentina, China, Germany, Indonesia, and Korea. During the same period, 224 foreign companies have registered more than $81 billion in securities in 329 U.S. public offerings. Over $41 billion of that amount represents registered equity offerings. As of September 9, 1994, there were a total of 637 foreign

reporting companies representing 40 countries listed or quoted on the U.S. public markets.

B. Disclosure and Accounting Standards

One of our goals at the Commission—and one we share with the securities regulators of many other countries—is to find ways to reduce regulatory barriers to multinational capital raising, while, at the same time, protecting the soundness and integrity of the capital markets. To achieve this goal, we are committed to the development of international accounting and disclosure standards acceptable in all jurisdictions. The ability to use one disclosure document to make a multinational offering would greatly reduce the barriers to international capital raising. As barriers to international capital raising are reduced, more companies will be willing to tap the U.S. capital markets and to have their securities traded in our public markets. By attracting additional foreign listings to the regulated U.S. markets, such standards would also allow U.S. investors considering or making investments in a greater number of foreign companies to enjoy the efficiencies and protections of the U.S. markets.

Since 1987, the Commission has been working with the International Accounting Standards Committee ("IASC")[1] through the International Organization of Securities Commissions ("IOSCO")[2] to develop accounting standards that IOSCO members might find acceptable in multinational offerings. In the past year, these efforts have yielded tangible results.

In October 1993, IOSCO recommended that its members accept cash flow statements prepared in accordance with International Accounting Standard ("IAS") 7, as amended, as one alternative to cash flow statements prepared in accordance with the various national standards for cash flow statements. In April 1994, the Commission adopted rules that allow foreign issuers to use IAS 7 in preparing their cash flow statements. This is the first time that the Commission has accepted an accounting standard other than a U.S. standard. The Commission also proposed, in April 1994, to accept certain aspects of other international accounting standards for foreign issuers.

In August 1993, an IOSCO working party informed the IASC of the necessary components of a reasonably complete set of accounting standards for enterprises undertaking cross-border offerings and listings. In June 1994, the IOSCO working party provided the IASC with its evaluation of the acceptability of existing accounting standards as elements of these "core standards." The Commission intends to continue working closely with IOSCO and the IASC as they work on these and other accounting issues.

In the area of non-financial disclosure, an IOSCO working party completed in 1991 a comprehensive survey on existing disclosure standards in fourteen of the developed securities markets. The working party is now in the process of evaluating proposals for acceptable disclosure standards that might be used by companies engaged in cross-border offerings and listings.

The Commission has also been working on disclosure issues on a regional basis, with the Council of Securities Regulators of the Americas ("COSRA").[3] In June 1994, COSRA's members endorsed a resolution regarding mandatory disclosure that addressed when disclosure should be provided, what disclosure should be provided, the methods of providing disclosure, and measures to assure the efficacy of a disclosure system.

C. Derivatives

One of the major developments in the world's financial markets in the past few years has been the birth and growth of the over-the-counter ("OTC") derivatives market. U.S. markets and market professionals have been the world leaders in derivative technology and development. When used properly, derivatives provide significant benefits to corporations, financial institutions, and institutional investors in managing the risks of their businesses and their financial assets.

Derivatives can also present difficulties, however, in today's global market, especially in dealing with market volatility and systemic risk. This is primarily because, like the increasing volume of cross-border trading, derivatives tie together activities in different markets and market segments. In this environment, the failure of a large firm could have collateral effects throughout the market, and the trading ac-

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[1] The IASC is an organization of international accounting standard-setting bodies; it has members from over 80 countries.

[2] IOSCO is an international organization of securities commissions and related organizations; IOSCO has members from about 75 countries.

[3] COSRA is an organization of the securities regulators of North, Central, and South America and the Caribbean; it presently has about 15 members.

tivity of firms reacting to a large market movement could exacerbate a market decline. It is thus important for regulators around the world, and in particular for the Commission, to seek to maximize the resilience of their own markets and thereby to enhance the protection of investors.

The Commission is working on several fronts to address the systemic and firm-specific risks associated with derivatives. These efforts include revised capital standards, increased disclosure, improved internal controls, and enhanced suitability standards. The Commission is also working with the securities industry to address the special issues raised by unregistered affiliates of securities firms formed for derivatives activities.[4]

The global nature of derivatives activity makes it imperative for global financial regulators to work together in addressing the challenges presented by derivatives. The Commission is committed to, and indeed is a leader in, this effort.

For example, in March of this year, the Commission, the Commodity Futures Trading Commission, and the U.K. Securities and Investments Board issued a joint statement recognizing the global nature of derivatives and identifying ways in which the three agencies can cooperate in their respective regulatory approaches to OTC derivatives. The joint statement is intended to provide a framework for enhanced international regulatory cooperation, particularly in the areas of:

- exchange of information,
- enforceable netting arrangements,
- issuer capital charges,
- management controls,
- customer protection,
- multilateral credit risk management arrangements, and
- accounting and disclosure standards.

The Commission also actively participates in discussions of derivative issues in IOSCO and, more informally, in discussions of these issues with the Basle Committee on Banking Supervision. Recently, these two organizations issued consultation papers discussing the importance of internal controls and other risk management tools in the derivatives context. The Commission supports the papers' emphasis on internal use of derivative management tools such as:

- an established framework of risk management policies, procedures, and controls,
- in-house expertise and resources,
- appropriate valuation and risk exposure measurement techniques, and
- systems to ensure adequate information and reporting.

In addition to these initiatives focused on OTC derivatives products, the Commission as a general matter requires regulated markets that trade standardized derivatives products to maintain adequate surveillance mechanisms. In this regard, the Commission encourages U.S. markets that trade derivatives based on foreign stocks, bonds, or indices to coordinate with the relevant foreign market where primary trading of such stocks, bonds, and indices occurs. When the Commission reviews proposals to trade such derivatives as options on foreign securities, index warrants, and equity linked notes the Commission generally requires that the U.S. market maintain adequate and enforceable mechanisms to share surveillance information with the relevant foreign markets.

D. Clearance and Settlement

Another major concern of the world's financial regulators is strengthening the world's securities clearance and settlement systems. Again, although the issues involved may seem complex and remote from the concerns of individual investors, in fact the clearance and settlement system is important to individual investors. Problems in the clearance and settlement system are particularly likely at times of severe market stress and high volatility; these problems can themselves exacerbate market stress and volatility, and ultimately injure millions of individual investors. It is in the interests of *all* investors to create a stronger, faster, safer clearance, and settlement system.

In the United States, the clearance and settlement system has generally proven capable of handling high volumes of trading and volatility. In 1993, the largest U.S. equity clearing agency, the National Securities Clearing Corporation ("NSCC"), processed an average of almost 700,000 transactions a day. The average daily value of the funds and securities settled through NSCC exceeded $60 billion in 1993. The

[4] For more details, see Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Concerning Derivative Financial Instruments, Before the Subcommittee on Telecommunications and Finance, House Energy and Commerce Committee (May 25, 1994).

primary U.S. depository, The Depository Trust Company ("DTC"), held securities valued at over $7.5 trillion in 1993 and processed over 98 million securities transfers.

The U.S. comparison, clearance, and settlement processes are among the fastest and most efficient in the world. Our clearing corporations and markets generally compare and confirm trade terms by the following morning and settle trades within 5 business days. In October 1993, the Commission adopted regulations, effective on June 1, 1995, to require most equity trades to settle three business days after the trade.[5] In comparison, although a few nations have adopted even shorter settlement cycles, the U.K. only recently required settlement within 10 days of trading, and a substantial portion of trades in both France and Italy still settle on a monthly cycle. The U.S. system also provides these services at far lower costs to participants than most clearance systems in use around the world today.

In addition to being fast and efficient, U.S. clearing systems are sound. The vast majority of equity transactions in the United States are cleared through continuous-net-settlement systems. In such systems, credit risk is minimized by netting each participant's transactions to arrive at two types of daily obligations: A daily net deliver or receive obligation for each security, and a single net payment or receipt, from the clearing corporation, for all transactions. In several other developed markets, including France and Japan, daily settlement obligations are based only on one day's trading and are not netted against the next day's obligations. In other countries, including Germany, Sweden, and the U.K., only money obligations are netted, and securities are still settled on a trade by trade basis.

Given the close links among the world's securities markets, however, it is not enough for the Commission to focus on the U.S. clearance and settlement system. The Commission has worked actively with IOSCO and industry groups in efforts to improve clearance and settlement systems worldwide. In particular, the Commission has been an active participant in the efforts of the Group of Thirty, a private group of financial leaders, to improve clearance and settlement systems. The Commission has worked to ensure that the U.S. clearance and settlement system meets the nine standards proposed by the Group of Thirty,[6] and has also encouraged its foreign counterparts to work to bring their clearance and settlement systems closer to or into compliance with these standards.

Other countries have taken major steps toward meeting the Group of Thirty recommendations. Both France and Sweden have reduced their standard settlement cycle to 3-day settlement while Australia, Canada, and Spain have reduced their settlement cycle as an initial step toward achieving shorter settlement times. Automated comparison and settling systems such as Australia's Clearing House Electronic Subregister System, France's Relit System, Hong Kong's Central Clearing and Settlement System, and the United Kingdom's CREST System, have been or are being developed to increase processing efficiency. Nations such as the Netherlands, France, and Switzerland have established stock lending programs in response to the Group of Thirty's recommendations.

E. Enforcement Cooperation

Enforcement cooperation provides another example of the importance, to the individual investor, of the Commission's international program. Those who wish to defraud American investors often use foreign subsidiaries or foreign accounts in an attempt to conceal their violations.[7] Thus, to protect U.S. investors and enforce the U.S. securities laws, the Commission often needs assistance and information from other nations. To obtain such assistance, the Commission has developed a network of close relations with its foreign regulatory counterparts, often formalized in memoranda of understanding ("MOU's").

The Commission now has MOU's with many of its major foreign regulatory counterparts, including those in Canada, France, Italy, Japan, Mexico, and the United Kingdom. The Commission continues to negotiate and enter into new MOU's, including an understanding entered in April 1994 with the securities regulator in China.

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[5] The Commission continues to work with the U.S. securities industry to ensure that this rule is implemented smoothly and efficiently. Among other initiatives, the Commission is working with industry groups to develop a uniform requirement that new issues of securities be eligible for automated depository transfer.

[6] The United States system already met, when these standards were proposed in 1989, seven of the nine standards. The two remaining standards are 3-day settlement for securities transactions and settlement of securities transactions in same day funds. As noted above, the Commission has recently adopted rules to require 3-day settlement in 1995. DTC and NSCC are leading the effort to convert from next-day to same-day funds settlement.

[7] For example, Dennis Levine, a New York investment banker, attempted to hide his insider trading by using Panamanian companies and a Bahamian branch of a Swiss bank.

The Commission's MOU's generally define and formalize procedures to request and provide information in connection with the enforcement by the Commission and its counterparts of their respective securities laws. Before entering into an MOU, the Commission and the foreign securities authority exchange information about their regulatory and legal systems, and work to develop an understanding that will suit their current circumstances. This process does not end with the signing of the MOU: The Commission and its counterparts often amend MOU's as legal, regulatory, and market circumstances change.

There is an increasing international recognition of the importance of MOU's and enforcement cooperation more generally. For example, earlier this year, COSRA's members adopted a resolution in which they agreed to assist one another, to the fullest extent possible, in obtaining information and testimony for the enforcement of their respective securities laws. Several nations have, in recent years, adopted legislation modeled on Exchange Act Section 21(a)(2), so that their national securities authorities may now use their compulsory powers to assist in investigations of possible violations of foreign securities laws.

The Commission's MOU's and other international enforcement efforts have significantly strengthened the Commission's ability to enforce the U.S. securities laws. The Commission now requests and obtains, on an almost daily basis, enforcement assistance from its international counterparts. There were 213 such requests in fiscal year 1993. The assistance and information we obtain from overseas is useful, often critical, in our enforcement cases. In return, the Commission frequently receives requests and provides assistance to foreign securities regulators; there were 232 such requests in fiscal year 1993.[8]

III. The Commission is Committed to Individual Investors

One of the great strengths of the American securities markets is the extent of *individual* participation in the markets. In 1990, there were more than 51 million Americans who owned equity securities directly or through stock mutual funds.[9] The figure today is almost certainly higher. As noted above, about half of the U.S. equity market, by market value, is owned directly by individuals, far more than in other major markets.

Since becoming Chairman, I have attempted to focus the Commission's attention on the needs of the individual investor, the ultimate consumer of securities and securities services. As discussed above, there are close links between the consumer issues and the international issues that face the Commission. It is no longer possible, if it ever was, to assume that international issues are of no interest to individual investors, or that the treatment of individual investors does not have international implications. Let me turn, therefore, to some of the Commission's "other" individual investor initiatives.

A. CONSUMER AFFAIRS

The Commission receives more than 30,000 complaints, inquiries, and other communications from consumers each year. As Chairman, I have reorganized and strengthened the Commission's Office of Consumer Affairs so that it can better handle the inquiries and problems of consumers. I have also formed a Consumer Affairs Advisory Committee to consider how the Commission can be more responsive to the needs of individual investors. And I intend, in the next few weeks, to meet with consumer groups across the country to learn about their concerns and discuss with them the Commission's work.

These efforts to strengthen the relations between consumers and the Commission have been supplemented by efforts to help investors make their own, well-informed, investment decisions. Earlier this year the Commission issued a brochure that gives investors basic information to help them make and monitor their investments. This brochure has been a resounding success: We have printed and distributed over 100,000 copies, and we have received a "Reinventing Government" award for it from Vice President Gore. The Commission is working on a second brochure targeted at mutual fund investors. The Commission has also recently moved to ensure that investors in wrap fee accounts receive a simple disclosure document that explains the nature of the "wrap fee" arrangement, the various parties involved, and the fees charged.

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[8] For more information, see Testimony of Michael D. Mann, Director, Office of International Affairs, U.S. Securities and Exchange Commission, Concerning the International Antitrust Enforcement Assistance Act, Before the Subcommittee on Antitrust, Monopolies, and Business Rights, Senate Committee on the Judiciary (August 4, 1994).

[9] New York Stock Exchange, Fact Book 1991, at 64.

B. Industry Sales Practices and Standards

In another area of concern to individual investors, the Commission is working on a variety of fronts to improve the sales practices and standards of brokers.

Recently, the Commission, working in conjunction with the self-regulatory organizations, completed a review of the hiring, retention, and supervisory practices of nine of the country's largest broker-dealers. As a result of this review, the Commission staff made a number of important recommendations to strengthen broker-dealer compliance systems and to improve the identification and disclosure of disciplinary problems of registered representatives. The Commission is increasing its examination and enforcement efforts targeted at problem brokers, and is planning a second joint examination "sweep" of small- and medium-sized firms to follow up the large firm project.

In addition to the consumer education efforts discussed above, the Commission is also working on broker education. The Commission is working closely with an industry group, the Council on Continuing Education, which is developing a curriculum for a continuing education program for registered representatives. Brokers will be trained to understand new securities products in order to better serve their customers and also will be tested on recently passed laws and regulations to improve broker compliance. Self-regulatory organization rules have already been proposed for comment, and we hope that the new continuing education system will be in place by July 1995.

Finally, the Commission is encouraging the securities industry to examine the relationship between sales practices and industry compensation and incentive practices. I have asked a group of industry leaders and outsiders to review these difficult but critical issues.

C. Mutual Funds

Average American investors are, more than ever, relying on mutual funds. The percentage of U.S. households that own funds has more than quadrupled since 1980, from about 6 percent to about 27 percent today. Over the same period, total mutual fund assets have increased even more dramatically, from $135 billion to over $2 trillion.

The growth of the mutual fund industry, and the growing reliance of individual investors on the industry, make mutual fund oversight one of the Commission's highest priorities. The Commission is committed to using both its preventive and punitive capabilities so that investors can continue to invest in mutual funds with the confidence that their trust will not be abused.

The Commission's staff has just completed a study of personal investing by fund managers at thirty fund groups, and, although the staff did not find widespread problems, the Commission will be making and proposing some changes in this area. The Commission is also actively reviewing the various issues raised by mutual funds' use of derivatives—disclosure, pricing, liquidity, leverage, and risk management—and we are making and proposing changes here as well. And the Commission has been working closely with Congress on legislation that would allow us to strengthen our overstretched inspection program.[10]

D. Municipal Securities

Individual investors are, increasingly, investing in municipal securities. Of the total of $1.2 trillion in municipal securities outstanding at the end of 1993, about $480 billion was held directly by individuals. Another $370 billion was held by investment companies, the shares in which are usually owned by individuals. Thus, directly or indirectly, individuals now own about 70 percent of the outstanding municipal securities, up from only about 45 percent less than a decade ago.[11]

As Chairman, I have made it a priority to improve both disclosure and behavior in the municipal securities market. Through voluntary discussions with the industry, and through the approval of Municipal Securities Rulemaking Board Rule G–37, the Commission has in the past year made significant headway in severing the pernicious link between political contributions and the municipal bond business.

In the area of disclosure, the Commission's goal has been to ensure that municipal investors know what they are buying, whether and how it is rated, and what they are paying. The Commission's actions and proposals in this area, which relate to

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[10] For more information on these issues, see Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Concerning Issues Affecting the Mutual Fund Industry, Before the Subcommittee on Telecommunications and Finance, Committee on Energy and Commerce, U.S. House of Representatives (September 27, 1994).

[11] *See* Board of Governors of the Federal Reserve System, *Flow of Funds Accounts, Flows and Outstandings*, Fourth Quarter 1993 (March 9, 1994).

such issues as the application of the anti-fraud provisions, continuing disclosure, increased price transparency, and disclosure of dealer mark-ups, have generated substantial discussion. We welcome that discussion; we look forward to working with those interested to improve upon the proposals.

Although much remains to be done in this area, the Commission's efforts over the last year have already caused the municipal industry to re-examine itself, to cast away some of its 19th Century practices, and to move itself forward into the 21st Century.

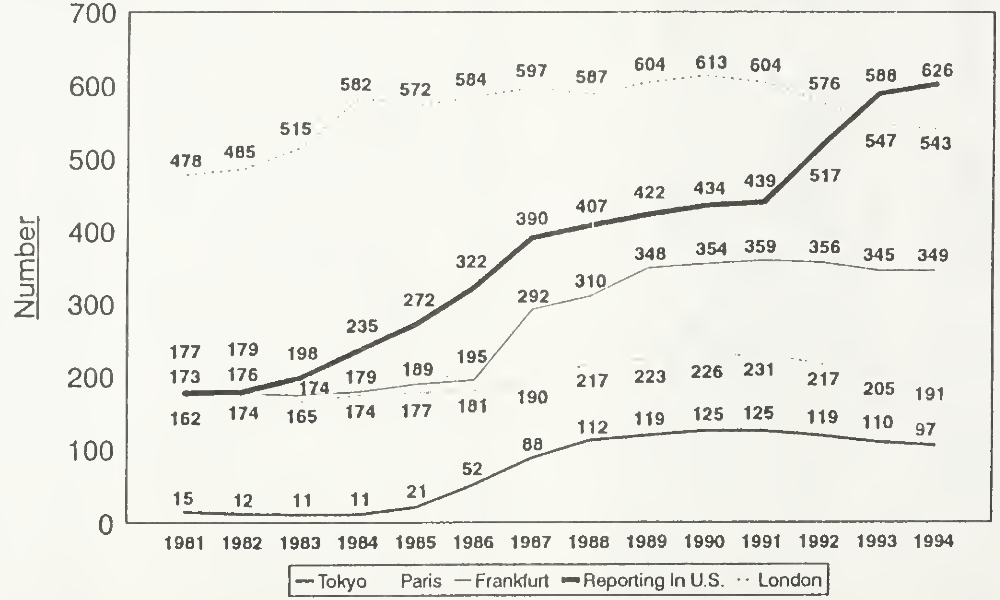
IV. Conclusion

The Commission is thus working, in many ways, to protect individual securities investors and to address the increasingly international character of the securities markets. These efforts are related. One reason why we must continue to protect, to the utmost of our ability, individual investors is that investor protection is one of the great competitive strengths of our securities markets. One reason why we must continue to address difficult international issues is that these issues have major implications for individual U.S. investors.

Chairman Riegle, the Commission would like to thank you for your support of the Commission during your 18 years in the Senate and your 10 years in the House. In particular, your work on the Market Reform Act and the Remedies Act will make a lasting difference in the work of the Commission. Senator Riegle, we salute you and the legacy you leave here.

Thank you.

Foreign Companies Listed on Major Foreign Exchanges and the U.S. Markets



Note: U.S. markets include all foreign reporting companies.
1994 data as of June 30, 1994.

PREPARED STATEMENT OF E. GERALD CORRIGAN

Chairman of International Advisors, Goldman Sachs & Co.

September 28, 1994

Chairman Riegle and distinguished Members of the Committee, I am pleased to appear before you this morning to share with the Committee my views on the "condition of United States capital markets and issues arising from the globalization of world capital markets." The complex issues that arise in this latter connection are profoundly important to the United States and to the world at large.

In order to provide a useful framework for analysis, I would like to begin my prepared remarks with a few observations on the process and implications of the globalization of capital markets. As this Committee knows very well, the extent to which finance in general, and capital market activities in particular, have been globalized in recent years is truly remarkable. Governments and private companies from a wide range of Nations now routinely tap global capital markets on a scale that only a few years ago would have been unimaginable. At the same time, institutional and individual investors now have easy and relatively low-cost access to a seemingly endless array of international outlets for their savings.

While there is no doubt that the globalization of finance is a plus for the community of nations, there is also no doubt that this process—as suggested in your letter of invitation—raises new challenges for policymakers and for practitioners alike. Allow me, therefore, to briefly discuss some of the major benefits that grow out of the globalization of finance before turning to the specific issues raised in your letter of invitation.

One of the most important benefits of the process of financial globalization is very subtle but it should not go unmentioned. Namely, I am convinced that the financial interdependencies that grow out of more integrated financial markets can be a powerfully constructive force in promoting better understanding and greater patience among nations. The higher degree of understanding can play a role in helping to foster improved harmony and cooperation between nations. In other words, if we can get it right, globally integrated finance and financial markets can help to provide some of the "glue" that can constructively bind together the nations of the world in what we all hope will be a period of sustained peace and prosperity.

In more immediate and less philosophical terms, it may be useful to think of the benefits of globalization of finance in terms of the identity between savings and investment. As students of economics know, global savings must equal worldwide investment. The sources of savings can only come from governments that run budget surpluses, households that save some of their current income, and corporations that earn a profit after taxes and dividend payments. The uses of those savings take the form of financing the deficits of governments that have an excess of spending relative to revenues as well as the financing the full range of private investments stretching from massive infrastructure projects to the shelf inventory in the corner grocery store.

At any point in time, most individual nations will have either a surplus or a deficit in national savings which—at the risk of over simplification—will be reflected as either a current account surplus or deficit. In turn, international money and capital markets are the primary instrumentalities through which countries with surpluses finance countries with deficits. Of course, governments, either directly or indirectly through government-sponsored institutions such as The World Bank and the IMF, also play a role in the process of distributing savings among nations. Statistical imperfections aside, because world savings must equal world investment, the combined current account positions of individual nations must net to zero. Therefore, levels and changes in interest rates and exchange rates are the *proximate* instrumentalities which bring about the international capital flows that equalize savings and investment at the level of individual nations thereby netting global current accounts to zero. Thus, the international financial system must play the vital role of mobilizing and distributing savings on a global scale—a process that is obviously central to the well being of the global economic and trading systems. Clearly, the more effective and efficient the international financial system, the better the economic prospects for all.

Looking to the future, there are a number of factors that strongly suggest that the role the international financial system plays in mobilizing savings and allocating those savings to their most efficient use within and across nations will become more important *and* more complex. For one thing, governments will likely play a smaller role in this process because they are not apt to have the financial nor political base to maintain, much less, increase their bilateral or multilateral external financing and foreign aid programs. Beyond that, we also know that the potential de-

mands for savings in the years immediately ahead, taking account of the requirements for growth, infrastructure, the environment, and the basic human needs of hundreds of millions of people, will far outstretch the supply of savings. We also *should* know, but sometimes forget, that while central banks can create money, they cannot create savings!!!

All of this, of necessity, implies that the marketplace, working through the mechanisms of interest rates, exchange rates, and the credit decisionmaking process is going to have to ration the limited supply of savings among an increasing number of potential claimants on those savings in a manner that must insure that those who obtain the use of others savings will put those savings to the best use in terms of overall economic efficiency. However, in a context of growing economies, there are some large questions that arise as to the possible implications of the manner in which the marketplace will equate savings and investment. For example, there is a question as to whether we may be looking at a long period in which inflation adjusted interest rates will be somewhat higher than historical benchmarks might suggest. More importantly, a question also arises as to whether the market driven process of allocating savings within and among nations may widen the gap between the economic "haves" and "have not's." The consequences of such an eventuality could, over time, have distinctly troubling implications in economic, social, and political terms.

One thing, however, is clear and that is that effective, efficient, and stable international financial institutions and markets are a necessary, but not sufficient, condition for sustaining economic growth in the United States and around the world. In other words, even the very best of international financial markets and institutions can only do so much. For example, in the face of myopic trade policies, efforts to regulate or control capital flows, or continued large scale governmental dis-savings in the form of budget deficits at the national level such as in the United States, the period ahead could prove to be extraordinarily difficult. Indeed, I can see no possible framework of broad-based economic progress unless it occurs in a setting of true openness in trade and finance and sustained discipline in monetary and fiscal policies. Unfortunately, I fear we are a long way from those ideals even though efficient markets are capable of papering over problems for a while. In the fullness of time, however, the marketplace will treat harshly even the largest of nations that fail to conduct their economic and financial affairs in a sound and prudent fashion.

While the preceding discussion is framed largely in the context of macro-economics and finance, it should also be noted, however briefly, that globalization of finance also brings with it considerable benefits at a more micro-economic level as well. Allow me to cite a few examples, as follows:

- U.S. taxpayers are major beneficiaries of global finance by virtue of the very large extent to which the rest of the world invests in Treasury Securities.
- The resurgence of growth and development in much of Latin America has been importantly fostered by global capital markets. Indeed, over the period 1990–93, capital flows into Latin America were well in excess of $100 billion, almost 40 percent of which took the form of foreign direct investment.
- Privatizations—which are bringing about important economic and political changes in many countries—simply could not occur on the scale we have seen were it not for highly efficient global capital markets. This is especially true in the rapidly developing countries in Latin America and Asia, but to a lesser extent, is also true in a number of industrial countries.
- More efficient global capital markets, and the competition they foster at both the national and international level, may be one of the few ways in which unused or underutilized savings can be better mobilized and utilized, thereby increasing the effective savings rate.
- Finally, globalization of finance and capital markets can produce a mechanism through which very large and expensive infrastructure developmental projects can be financed without placing further pressures on budgetary deficits.

In short, whether it is in broad geopolitical terms, or in terms of a more effective means of mobilizing and distributing global savings, or in terms of greater flexibility for both savors and investors at the micro level, the globalization of finance is bringing very large benefits on a wide scale.

It should also be emphasized that U.S. financial institutions are playing a major role in the development of the global financial marketplace. Indeed, while much has been said about the fresh competitive energy of the U.S. industrial sector, the strong leadership and global competitive edge of the U.S. financial sector is a major plus for our country and the world. Turning to the condition of the U.S. securities industry and markets more generally I would offer the following observations:

- U.S. capital markets, starting with the U.S. Government securities market, remain the most liquid, efficient, and effective markets in the world.
- New York remains one of the three most important—if not the most important—international financial center of the world.
- U.S. institutions and markets remain the most dynamic and innovative in the world.
- On the whole, the capital position of most major securities firms have strengthened appreciably over the past several years of bull markets even if 1994 has been very difficult for earnings and the internal generation of capital.
- Due to increased volatility, greater complexity, and reduced reaction times, the managerial challenges facing securities firms, both small and large, are continuing to grow even as very sizable commitments of resources are being devoted to control and risk management systems.
- Finally, income flows and profits, which have always had a high element of cyclical volatility, are, if anything, likely to be even more variable in the period ahead.

To summarize, U.S. securities markets and firms are world leaders; the industry as a whole is sound; but the challenges of the day and beyond are large indeed. Let me conclude, therefore, with a few observations regarding the major issues that U.S. institutions will have to face over the next few years as global interconnections continue to grow.

At the most general level it goes without saying that the greatest challenge facing U.S. institutions in the years ahead will be the task of maintaining the trust and confidence of the marketplace, including individual and institutional creditors, counterparties, and customers. That will depend importantly on maintaining the profitability needed to generate fresh capital and to provide the financial flexibility which must be present to manage growth, innovation, and the rapidly increasing costs associated with the controls and technological infrastructure needed to operate safely in global markets.

As I see it, the challenge of maintaining profitability, trust, and confidence in the period ahead will rest importantly on three closely related issues. They are:

First: I can see no near term relief from the patterns of increased market volatility and short-term exaggerations in price movements in financial markets. To an important degree—and especially in times of stress—these tendencies are amplified by a degree of linkage in asset price movements across markets and across natural boundaries that seems to defy the so-called fundamentals. One recent example of this phenomena was the broad-based declines in fixed income markets throughout the world earlier this year.

While there are many differing explanations offered as to the reasons for this apparent change in the behavioral characteristics of financial markets, none are fully satisfactory. Most attribute some of the causation to the speed of information flows, the application of very high technology to trading activities, the continued increase in the institutionalization of savings, and the fears on the part of practitioners of being left on the wrong side of a major market move which produces something of a "herd" instinct.

There is, of course, also the suggestion that volatility and related problems are caused by the widespread use of financial derivatives. While the risks associated with financial derivatives remain a major concern to me, it is not at all clear to me that derivatives "cause" volatility. Indeed, a case can be made that derivatives may reduce volatility. But, whether derivatives increase or decrease market volatility is not the central issue since I seriously doubt that the protagonists for either point of view will ever be able to mount a truly persuasive argument in their favor. The central issue, as I see it, is risk. This raises the question of whether we have done all that can reasonably be done to identify and contain the risks—including the risk to the system—associated with derivatives.

While much has been done to better understand and control the risks associated with derivatives, more effort is needed. That is why, in testimony before the House Subcommittee on Telecommunication and Finance early this year, I outlined a number of steps that I believe should be taken to further contain the risks associated with financial derivatives. An except from that testimony outlining those steps is appended to these statement. In calling the Committee's attention to those suggestions, I want to again emphasize that I believe sufficient legislative authority already exists to get the job done. Thus, at this time, I do not favor legislation in this area.

Second: The second area of general concern relates to what, for lack of a better term, I will call "market disintermediation." What I have in mind in this regard is the danger that an economic, financial, or political shock can trigger an abrupt change in market psychology which givers rise to a major shift in investor pref-

erence for a generic class of assets such as high-yield bonds, mortgage-backed securities, emerging market debt, or country specific stocks and bonds. To the extent such markets are—or become illiquid—this phenomenon of "market disintermediation" can take on cumulative characteristics.

The potential for this type of phenomenon brings with it several important implications including the following: (1) we must search out ways—including still further improvements in payments, clearance, and settlement systems—that will work in the direction of enhancing the liquidity of markets on a broad scale; (2) market practitioners must more fully learn to guard against the "illusion of liquidity" even in markets that have behaved well in times of stress; and (3) even greater emphasis must be placed on the time honored dictate of portfolio diversity. As markets mature and as learning curves flatten out, the tendencies toward "market disintermediation" may fade. If not, consideration may have to be given to approaches that would provide for a larger cash cushion in some markets through such devices as margins or haircuts.

Third: The final area I want to mention relates to regulatory and supervisory philosophy. Since the 1930's, the track record of efforts aimed at regulation of securities markets and securities firms in the United States has been truly outstanding. To a very considerable extent, the underlying thrust of regulatory policy has been framed in terms of (1) broad-based efforts aimed at investor protection and (2) the view that with both adequate capital standards and mark to market accounting practices in place, the liquidity of a securities firm (or at least the regulated broker-dealer) is such that even in the most extreme of cases an individual firm can be quickly and easily liquidated with little risk to the markets or the system.

While the emphasis on investor protection is entirely appropriate, it may be that some fresh thinking is needed with regard to more macro orientated prudential policies as they pertain to securities markets and firms. As an example, I believe the point of view to the effect that a failing large broker-dealer—to say nothing of a large multi-faceted securities firm—can be quickly and easily liquidated is highly suspect. In raising this question of regulatory and supervisory philosophy, I have no specific suggestions to offer at this time since I regard the topic as food for thought.

In closing, Mr. Chairman, let me repeat a point I made at the outset; namely, the globalization of finance is an extremely important and complex subject. My remarks today only scratch the surface but I hope they are broadly responsive to the Committee's interests.

Thank you.

Excerpt from Testimony by E. Gerald Corrigan
before the
Subcommittee on Telecommunications and Finance of the Committee on Energy and Commerce
United States House of Representatives
May 10, 1994

First: All major market participants, including non-financial firms that are significant end users of derivatives, need to redouble their efforts to insure that risk management, information, and control systems are up to state-of-the-art standards. As a part of this effort, boards of directors and top managers should insist that all such firms undertake a rigorous self-analysis relative to the original G-30 recommendations and relative to the findings of the G-30 III survey of industry practices. Among others, the objective of this exercise should be to achieve accurate and timely consolidated credit and market risk monitoring on the part of all major institutions in these markets. Over a longer time frame, the goal should be to push these monitoring efforts to the limits of technology and practicalities in order to achieve intra-day monitoring capabilities on a broad scale.

Second: Working together, individual firms, exchanges, clearinghouses and central banks should be even more aggressively pursuing ways to strengthen clearance, settlement and payment systems. These efforts should focus on programs aimed at (1) shortening and standardizing the timing gaps between trade date (and time) and final payment; (2) the more widespread use of same day delivery against payment systems for securities transactions; (3) moving toward same day final payment in clearing houses and exchanges; and (4) further strengthening the operational reliability of major processing systems. While it may not be obvious to all, such improvements in the "plumbing" of the financial system can work in the direction of enhancing market liquidity across a wide spectrum of financial instruments This is important because greater market liquidity should work in the direction of strengthening the capacity of markets to absorb more smoothly sudden shifts in market psychology.

Third: We must move more aggressively to establish a standard set of definitions applicable to financial disclosure and reporting requirements for widely traded derivative instruments. This may sound like a narrow and technical issue, but it is not. It is at the heart of the ability of firms and regulators to make consistent

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judgements as to the risks associated with given portfolios of derivatives. As things now stand, the gaps in uniform definitions and disclosure standards are a major factor in explaining the considerable variation in the manner in which firms responded to the G-30 III questions that are relevant to these issues. While it would be unfair not to acknowledge the progress that has been made in this area, the fact remains that much remains to be done.

Fourth: Major market participants need to work with regulators and supervisors to assure the legal enforceability of derivative transactions, both within and across jurisdictions. Particular attention should be paid to removing any legal uncertainty with respect to the enforceability of netting arrangements both nationally and internationally. Dealers and end users also should work together to establish greater standardization in documentation to further promote liquidity and stability in these markets throughout the world. All of these steps, which are included in the G-30's list of recommendations, are critical to reducing risk and promoting certainty in the international derivatives markets. Here, too, I recognize that while significant progress has been made, more can and should be done.

Fifth: I believe that consideration should be given to the possibility of seeking to establish voluntary minimum standards for disclosure, credit and market risk controls, and customer suitability that could apply broadly to all major market participants in derivatives. In practice this will be very difficult, especially if applied nationally and internationally, and to both regulated and non-regulated entities. However, one way some progress might be made in this direction entails the development of such minimum standards by a private sector group, such as the G-30. While standards developed in this fashion would have no binding authority, they could serve a very useful purpose. For example, to the extent prominent individual firms were to voluntarily and publicly commit to comply with such standards, their actions would put great pressure on others to do so. Indeed, if some firms -- acting on their own and in their own best interest -- refused to do business with firms that did not voluntarily comply with such standards, the pressures could

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be very great. The obstacles to such a workable framework of voluntary minimum standards are formidable, but the concept should not be rejected out of hand.

Sixth: While the steps outlined above constitute a building block approach to the dual goals of greater safety and greater efficiency, it remains true that the international community of banking and securities regulators-- together with the appropriate officials of the European community-- still are faced with the enormous challenge of achieving greater cohesion and consistency as it applies to minimum capital standards. Under any circumstances, this will take time. And, based on my experience as Chairman of the Basle Committee, I know it will not be easy. Yet, in the fullness of time, I am hard pressed to believe that the legitimate interests of individual firms or groups of firms or individual regulators or groups of regulators cannot be accommodated in ways that permit significant movement in the direction of greater consistency in prudential standards and greater harmony in market practices.

SUMMARY OF PREPARED STATEMENT OF FELIX G. ROHATYN

SENIOR PARTNER, LAZARD FRERES & COMPANY

FORMER CHAIRMAN, MUNICIPAL ASSISTANCE CORPORATION, NEW YORK, NY

Mr. Chairman and Members of the Committee: I appreciate the opportunity to speak to some of the issues raised by the globilization of world capital markets. I will summarize my testimony. This leads me to the following conclusions:

- Strong economic growth in the developing part of the world is critical to maintain acceptable growth in the developed Western World.
- Huge amounts of capital will be required to support such growth.
- The amounts required will be far in excess of what can be supplied by the West and will require rapidly growing active and efficient capital markets in countries such as China, India, Latin America, etc.
- These markets, many of which exist today, will have to be connected with the more advanced Western markets to form a truly integrated global financial system.
- Such an architecture will require compatible infrastructures on the part of developing countries both as to technology but more importantly dealing with rights of ownership and protection of capital.
- The size and power of global financial markets require compatible securities and banking regulation. Great care must be exercised to limit the dangers of excessive speculation and little-understood off-balance sheet risks.
- The key to the stability of the World's Financial System is the strength or weakness of the dollar.

The single most important economic issue facing this country today is the strength or weakness of the dollar. This is critical for three reasons:

(1) A weak dollar is inflationary as higher prices for imports cause domestic producers to raise prices;

(2) A weak dollar makes U.S. investment abroad more expensive which, in a globally interconnected economy, has a negative impact on U.S. competitiveness;

(3) Most importantly, a weak dollar has a negative impact on the huge financing requirements of the U.S. Government.

The explosion in the national debt, growing from $1 trillion to $4 trillion in the last decade, combined with a desire to create budgetary savings by shortening its maturities, has resulted in a huge refunding calendar for the next 5 years. A total of about $2 trillion of Treasury bonds and notes comes up for refinancing, in addition to the needs to finance the ongoing deficits which will amount to another $1 trillion or so, during this period. The weakness of the dollar has already reduced foreign participation in Treasury financings significantly; Japanese institutions which routinely took one-third or so of our Treasury financings are no longer participating at anything approaching these levels. Although there have been recent reports that some of the Central Banks of smaller developing countries were making significant dollar investments, these are neither certain nor sizable enough to make up for the loss of Japanese participation. The fact that there is a rapidly growing outflow of American investment toward emerging markets as well as Europe, makes it critically important that we maintain more than offsetting inflows of foreign capital to the U.S. as long as our Government borrowings remain as high as they are. To maintain past levels of foreign investment in our governmental financing requirements between now and 2000 would require purchases of about $1 trillion by Japanese and other foreign investors. This can only be accomplished in one of two ways:

(1) A strong dollar and continued confidence in the dollar, coupled with reasonably low-interest rates; or

(2) Constantly escalating interest rates to offset anticipated losses due to a weakening dollar.

The latter scenario would be very negative to the U.S. economy; the short-term positive impact of a cheap dollar on U.S. exports would be more than offset by the slowing economy and rising inflation as a result of high-interest rates.

(1) A financial crisis, once started, is more and more difficult to stop. Monetary policy alone cannot deliver growth, low-interest rates and a strong dollar when the world markets say otherwise. In order to be safe, we have to do what is in our control as much as possible: Reduce our borrowing requirements, strengthen the dollar and lower interest rates to reduce the pressure on the capital markets. This can only be done with sustained and continued reduction in the budget deficit; this is no time for any type of tax cut. The key to this effort could be the success of the

Kerrey-Danforth Commission in making long-term inroads on entitlement spending. A credible 5-year plan coming out of that commission, which would bring the expense side of the budget into balance and providing for a separate capital budget, would have a very positive impact on all these variables. Allowing the financial bubble to get bigger will only cause a greater problem at some point in the future.

(2) There should be a separate and comprehensive organization comparable to GATT for investment just as there was a GATT for trade, even though some aspects of investment are now covered under GATT. Only through such new arrangements will Western investors—including pension funds, insurance funds, mutual funds, and others with fiduciary responsibilities—get the kind of protection they will require if they are to make large amounts of capital available. As the world's largest capital market, the U.S. is also in a position to propose that international procedures to protect investors be phased in over a definite period, say by the year 2000. And the U.S. Government should make such phased-in protection a condition for investment abroad by U.S. fiduciaries.

(3) We are presently encouraging countries all over the world to adopt capitalism. However, in too many cases, the capitalism they adopt is the type of capitalism we practiced at the turn of the century. It could be called "cowboy capitalism." It took us many decades, plus a Depression, to adopt our present-day capitalism, with its architecture of laws, regulations, institutions, customs, and technology. This is a very complicated structure and yet it is vital for countries newly entering this system, to understand its various aspects in order to adapt themselves for the 21st Century. The U.S. Government should constitute a permanent task force, consisting of representatives of the SEC, the Fed, the Treasury, the Attorney General, and various other bodies, to work with and advise foreign governments on a comprehensive basis, as to the legal and regulatory architecture of modern-day capitalism.

If there is a "New World Order," it is in finance and economics. It is driven by globalization, communications, and technology. And, because it is huge and new, it is quite unpredictable and should be approached with care and humility. The current arguments as to the tradeoffs of growth, unemployment, and inflation are a good example of conventional assumptions. Where is the empirical evidence that 6 percent unemployment is the lowest tolerable level of unemployment without danger of inflation? Does anyone know how much capacity has really been added to the U.S. economy after 10 years of dramatic restructuring and downsizing? What is the impact of foreign competition and wage rates on U.S. costs? No one really knows, but every statement and every statistic has a tremendous impact on the financial markets as long as a so-called "expert" is the source.

The recent volatility of securities markets here and abroad is a warning that while huge amounts of capital, some of it highly speculative are overpowering the world financial system, our arrangements for protecting that capital are inadequate. So are arrangements for raising the capital that the developing countries will urgently need. We are now nearing the fiftieth anniversary of the institutions created by the Bretton Woods Agreements—The World Bank and the IMF. It is time to review the structure of the world's financial system not only to increase its potential for raising living standards but to reduce the risk of enormous damage from a breakdown that could not be locally contained. In the meantime, we should do what is in our control to reduce those risks and improve our position; we should continue to reduce our deficit, reduce our borrowing needs, and protect the dollar.

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PREPARED STATEMENT OF FELIX G. ROHATYN

SEPTEMBER 28, 1994

Mr. Chairman and Members of the Committee: I appreciate the opportunity to speak to some of the issues raised by the globalization of the capital markets.

We have recently seen that the "New World Order" heralded by the collapse of communism is anything but orderly. The Europe of Maastricht is still far in the future; the transition of the FSU to market economy and democracy may be even further in the future; North Korea flirts with nuclear weapons, the former Yugoslavia slides back into the Middle Ages and Cuba, Haiti, Rwanda, and Somalia provide continuing challenges. However, despite the regional chaos, one development has gone ahead relentlessly and on a truly worldwide basis: The global capital markets are here. A financial umbilical cord girds the globe today, tied together by modern data processing and communications technology, and operating 24 hours a day, 7 days a week. The continued growth and stability of this market is vital for the growth of the developing world; it is equally vital for the West. Without rapid

growth in the developing world, the West will be in difficulty. This can be seen by the fact that U.S. exports are currently buoyed by demand from countries outside of Europe, Canada, and Japan. During the past 3 years, exports to other countries that make up the G–7 (Japan, Germany, Canada, United Kingdom, France, and Italy) have grown at an annual rate of only 0.6 percent. Shipments to the rest of the world have risen at a 7.6 percent pace. Although Europe and Japan are likely to recover over time, the relative growth differentials are likely to continue unabated, unless capital flows are impaired.

The economist, Henry S. Rowen, recently published an article in the *Wall Street Journal* estimating growth rates in what he called "Rich Countries" and "Non-Rich Countries" between 1990 and 2020. It showed "Rich Country" output growing from $13 to $24 trillion over the period for an average annual growth rate of less than 2 percent per annum. "Non-Rich Country" output grew from $9 trillion to $34 trillion over the period or over 4 percent per annum. These growth rates were computed on purchasing power parity as used by The World Bank; these do not produce exact figures, but they are indicative of the fact that high growth in the non-rich parts of the world is needed to maintain minimum acceptable growth in the West. It is also obvious that to produce added output of over $25 trillion in the "Non-Rich" part of the world, huge amounts of capital will be required. Secretary Bentsen's recent estimate that the Far East (minus Japan) would spend $1 trillion on infrastructure alone during the next decade underlines the needs for huge amounts of development capital. It is worth remembering that the original Marshall Plan consisted of $16 billion, to be disbursed over a 4-year period; this is about $100 billion in today's dollars or $25 billion per annum. No combination of Western public and private investment can provide more than a fraction of the presently required amounts given the slow growth and budgetary constraints of Western countries. However, Western expansionist trade and investment policies will accelerate the required internal capital generation in large developing countries, if properly supported by political stability and healthy world capital markets.

It is crystal clear that this reality requires major developing countries to establish domestic capital markets of sufficient depth, transparency, and integrity so as to encourage and mobilize domestic savings as well as to tap into the global savings pool represented by the rest of the world's capital markets. These will be heavily influenced by modern legislative reforms and financial and monetary policies of currency stability and low inflation. A global competition for capital will drive economic and political reforms, which in turn will be needed to mobilize domestic and foreign savings.

A preoccupation with bilateral trade balances, especially our trade deficits with Japan and China, has taken precedence over the continued nurturing and protection of global capital flows. They are, however, interconnected. Japan's $130 billion current account surplus, a direct result of its trade surplus, is helping to keep interest rates down in Asia and is helping the liquidity of SE Asian countries. With total investment in emerging markets now up to $180 billion (up from $2.4 billion 7 years earlier) no wonder some of these markets went into a tailspin when the United States and Japan appeared headed for a confrontation. The trade deficit with Japan must come down but it can, as a practical matter, only happen gradually and should be resolved with as little public acrimony as possible. Japan will have to meet its responsibilities as a global economic power both by reducing its trade surplus and maintaining its financial support in foreign markets.

Direct foreign investment should be as important a preoccupation as trade in the elaboration of our economic policies. Foreign investment generates both trade and employment. Foreign investment in Japan is as difficult as breaking its trade barriers and it has largely been ignored. Japan has the lowest rate of foreign investment of any G–7 country. We should put as much pressure on Japan to open up to foreign investments as we have on trade. The NIKKEI market average is down 50 percent from its high; Japanese banks, insurance companies, and other portfolio owners are in serious financial difficulties. This would be the time for United States corporations to be in a position to aggressively acquire stakes in Japanese companies. Such ownership would not only improve trade flows, but would create a powerful political dynamic which only actual presence in a market creates. An aggressive investment policy vis-à-vis Japan would obviously dictate a "strong dollar" instead of the "weak dollar" policy we are presently following. But history teaches us that strong money always wins out over weak money, and a weak dollar has done nothing to improve our trade balance with Japan. It is also an underlying factor in the inflation fears presently creating such uncertainty in the financial markets.

Reciprocity and open investment should be our policy here and abroad, with no limitations other than security-related exceptions.

Four conclusions can be drawn from the situation I have been describing:

(1) If the mature Western economies themselves are to maintain reasonable rates of growth, consistently strong growth must also take place in the developing world;
(2) The requirements for capital to finance that growth are beyond the capacities of the West, either from private or public sources;
(3) Global growth, therefore, requires not only direct investment by private and public foreign capital in the developing countries but also large-scale domestic investment by those countries themselves. This will only take place if savings within those counties increase along with their GDP and are directed toward domestic investment and if efficient capital markets can be created in each country.
(4) These local capital markets will gradually have to be connected organically to the global financial marketplace.

The global interconnection of capital markets as a result of new communications and data processing technology requires that greater attention be paid to the very nature of these markets. It is pointless and even dangerous to connect systems which appear to be similar on the surface, but are really disconnected in their reality. Trying to connect two railroad systems with different track widths would be a dangerous exercise; the same would apply to air traffic control systems using different languages, radio frequencies, and spacing requirements. To some extent, these are similar to the kinds of problems to be faced as very diverse capital markets are tied together in a global system; the capital markets of the developing world will have to be brought up to the highest standards of the Western world.

The American capital markets evolved since the end of the 19th Century from the boom-and-bust frontier-type capitalism of the 1910's and 1920's into the world's most broad-based and sophisticated financial system at the end of the 20th Century. The mainstays of the system involve the country's legal system; its financial institutions and savings systems; its banking system; and its communications and data processing technology. New Deal legislation of the Depression set the legal underpinnings of the modern system. They are heavily based on disclosure requirements and anti-manipulative laws aimed at preventing the speculative abuses that led up to the crash of 1929. The disclosure aspects also require accounting standards of a high order. These issues were covered by the Securities Acts of 1933 and 1934 and the creation of the SEC. The soundness of the banking system was reinforced by the independence of the FED combined with Federal Deposit Insurance which assured depositors of the safety of their assets. Savings were encouraged by the creation, also in the 1930's, of the modern pension system which made employer contributions tax-deductible while allowing tax-free accumulation of profits in the pension funds. In 50 years this has created a savings and investment pool of almost $3 trillion. Finally, electronic and communications technology facilitated a nearly paperless system which easily handles 300 million shares per day in the NYSE plus huge turnover on the ASE and NASDAQ. It was only in the late 1960's and early 1970's that turnover of as much as 10 million shares a day created a back-office crisis that almost brought the NYSE down.

The American political system may not be the model that every developing country may wish to adopt immediately; however, the American capital markets should serve as the model for the world's new economies to strive for. The legal protections; the levels of disclosure; the variety of financial instruments; the technical capabilities of the system are all standards for the capital markets of the future. Their achievement will be required to enable true global markets to mobilize domestic savings as well as attract foreign capital.

In the developing world, there will be fierce competition for such capital, since economic growth will depend on it, and since capital will become more choosy. After the current speculative fever dies down, capital will insist on modern legal and credit systems; real transparency; political stability; and independent central banks. Capital is not ideological; it is, however, both nervous and greedy. A country like India will accelerate the liberalization of its foreign trade and investment policies because, otherwise, it will not attract sufficient capital to finance transition to the 21st Century. Its main competition will be China. China, in turn, will have to reform its political system and its human rights policies to keep pace with economic reform. China's attraction is high growth; India's is relative stability and Western-type institutions. Both are potentially huge markets. The competition for capital between these two countries will be fierce and will push both of them to further reform; China politically, and India economically.

Notice should also be taken of the rush of more traditional institutions such as American mutual funds and pension funds into foreign markets not all of which may be as liquid or as transparent as the developed Western markets. The decrease in U.S. interest rates and the inflation in financial asset values, has created a frantic search, by money managers, for higher returns. These were achieved in the last

year or two by the spectacular performance of emerging country markets. Poland, the Philippines, Indonesia, Thailand, Malaysia, etc., richly rewarded investors over the recent period. United States investment houses now compete with each other to enter these markets setting up offices in Beijing, Singapore, Djakarta, etc.

The influx of foreign capital to China and other developing countries is a healthy and necessary movement. Care must be taken, however, to protect the investors from the speculative fever that has been created. Many of the speculative risks are created by markets that are closer to the American securities markets of the 1920's than to the legal and other structural underpinnings required by our markets in the 1990's. If speculative excesses erode the confidence in emerging markets, political reform, and economic growth in the developing world will be crippled, to the significant detriment of the West as well as to the developing world. U.S. pension funds and similar institutions now own global equities worth about $170 billion and plan to raise this to $400–$450 billion over the next few years. A loss of confidence due to 1920's-type market excesses would slow this flow of funds significantly.

It is also worth noting that the rush to invest in emerging foreign markets has a direct impact on foreign exchange movements. As U.S. institutions invest larger and larger amounts abroad, they become significant players in foreign exchange trading. The level of investment flows will have more and more impact of foreign exchange rates, as opposed to historical factors such as trade balances or interest rate differentials. In smaller countries with limited markets, foreign exchange rates will become significantly more volatile.

Another factor has to be taken into account as we look at global capital markets. We need to differentiate between *speculation* and *investment* since today much of the world's capital movements are speculative rather than long-term in nature. They can be highly destabilizing and potentially quite dangerous. Excessive borrowing did not disappear as the 1980's came to an end; it simply shifted in its nature.

Speculative investments are not limited to hedge funds. Banks and large securities firms, here and abroad, carry out the same type of activities for their own accounts as hedge funds do. In addition, the explosion over the past 10 years in the use of "derivatives" is a further potential risk to the stability of the financial system, even though some of these instruments are intended to do just the opposite.

While derivatives were originally designed to be part of sophisticated risk management techniques for large, professional investors, they have, in many cases, produced just the opposite result. Either because of improper use or because of unexpected changes in historical patterns, huge losses have been incurred by a variety of investors in widely different parts of the world. Properly used, and carefully overseen, derivatives can be a useful tool in a financial risk management just as the development of the futures markets significantly helped agricultural development in the United States. However, the huge amounts now involved, together with the dynamics of instantaneous information and reaction, may create unforeseeable stampedes with very dangerous results. The need to shore up mutual funds whose shareholders had been subjected to unexpected losses, points up the need for much greater care.

The need to maintain a strong and growing flow of worldwide capital must be combined with the need to regulate and protect that capital (and The Financial System) from excessive speculation and illegality. It must be remembered that it was the combination of Federal Deposit Insurance and the Securities Acts of 1933 and 1934 that set the stage for U.S. economic growth after the Depression. The communications technology and the sophistication of new financial instruments require a new look at the regulatory framework of banks and securities markets on a global basis. In addition, both in the U.S. and abroad, the activities of banks and securities firms are more and more similar. In the U.S., the separations created by the Glass-Steagall Act have all but disappeared.

The beginning of any new process of regulation has to be adequate disclosure. Particularly in the case of derivatives, balance sheets become meaningless, especially for banks and other financial institutions, when more assets and liabilities are carried in footnotes to the financial statements than on the balance sheet itself. Accounting standards should be tightened so that creditors and stockholders have a clearer understanding of the levels of risk, the reserves set against such risk, and the adequacy of the capital supporting. These standards should apply equally to all financial institutions, not only banks and securities firms but corporations that, in come cases, have turned their treasury departments into speculative profit centers by using derivatives as a way to increase their earnings. Their shareholders should be able to evaluate the risk and to judge the quality of the earnings. Whether or not more capital is required to support any or all of the current speculative activities will become evident when stricter standards of disclosure are set and the financial markets react to the risks disclosed. The U.S. banking authority and the Bank

for International Settlements in Basel, have called for some of these actions. Since these activities are global, any such plans to survey and protect against risks must include overseas regulators, mainly in Western Europe and Japan. There must also be tighter oversight and accountability with respect to practices used to sell these instruments.

At the same time, global capital markets require that much greater efforts be made to guarantee international investors the kinds of protection now afforded by American securities legislation. The recent attempts of the European Union to encourage regulations of this kind have some distance to go, since Germany has only now introduced legislation requiring higher disclosure standards, more adequate protections for minority shareholders, and severe penalties for insider trading. Daimler-Benz recently was the first, and so far the only, major German company to adopt the accounting standards that have for years been required by American securities laws in order to obtain a listing on the New York Stock Exchange.

If the countries of the developing world are to have access to increasingly large amount of foreign capital, while also encouraging their citizens to invest their savings, worldwide investment standards have to be adopted. There should be a separate and comprehensive organization comparable to GATT for investment just as there was a GATT for trade, even though some aspects of investment are now covered under GATT. Only through such new arrangements will Western investors—including pension funds, insurance funds, mutual funds, and others with fiduciary responsibilities—get the kind of protection they will require if they are to make large amounts of capital available. As the world's largest capital market, the U.S. is also in a position to propose that international procedures to protect investors be phased in over a definite period, say by the year 2000. And the U.S. Government should make such phased-in protection a condition for investment abroad by U.S. fiduciaries.

We are presently encouraging countries all over the world to adopt capitalism. However, in too many cases, the capitalism they adopt is the type of capitalism we practiced at the turn of the century. It could be called "cowboy capitalism." It took us many decades, plus a Depression, to adopt our present-day capitalism, with its architecture of laws, regulations, institutions, customs, and technology. This is a very complicated structure and yet it is vital for countries newly entering this system, to understand its various aspects in order to adapt themselves for the 21st Century. The U.S. Government should constitute a permanent task force, consisting of representatives of the SEC, the Fed, the Treasury, the Attorney General, and various other bodies, to work with and advise foreign governments on a comprehensive basis, as to the requirements of modern-day capitalism.

In closing, I would like to focus on what I believe to be the single most important economic issue facing this Country today: The strength or weakness of the dollar. This is critical for three reasons:

(1) A weak dollar is inflationary as higher prices for imports cause domestic producers to raise prices, as we see now with the auto industry;

(2) A weak dollar makes U.S. investment abroad more expensive which, in a globally interconnected economy, has a negative impact on U.S. competitiveness;

(3) Most importantly, a weak dollar has a negative impact on the huge financing requirements of the U.S. Government.

The explosion in the national debt, growing from $1 trillion to $4 trillion in the last decade, combined with a misguided attempt to create budgetary savings by shortening its maturities, has resulted in a huge refunding calendar for the next 5 years. A total of about $2 trillion of Treasury bonds and notes comes up for refinancing, in addition to the needs to finance the ongoing deficits which will amount to another $1 trillion or so, during this period. The weakness of the dollar has already reduced foreign participation in Treasury financings significantly; Japanese institutions which routinely took one-third or so of our Treasury financings are no longer participating at anything approaching these levels. Although there have been recent reports that some of the Central Banks of smaller developing countries were making significant dollar investments, these are neither certain nor sizable enough to make up for the loss of Japanese participation. The fact that there is a rapidly growing flow of American investment toward emerging markets as well as Europe, makes it critically important that we maintain inflows of foreign capital to the United States as long as our Government borrowings remain as high as they are. To maintain past levels of foreign investment in our governmental financing requirements between now and 2000 would require purchases of about $1 trillion by Japanese and other foreign investors. This can only be accomplished in one of two ways:

(1) A strong dollar and continued confidence in the dollar, coupled with reasonably low-interest rates; or

(2) Constantly escalating interest rates to offset anticipated losses due to a weakening dollar.

The latter scenario would be very negative to the U.S. economy; the short-term positive impact of a cheap dollar on U.S. exports would be more than offset by the slowing economy and rising inflation as a result of high interest rates.

We should also be very respectful of the power and size of the global markets and our inability to predict economic events with any degree of accuracy. In the 1970's, recycling petrodollars was all the rage, which resulted in the Third World debt crisis which almost wiped out our banking system; this was followed by junk bonds and real estate which did the same for the S&L's in the 1980's; portfolio insurance was the next darling of the experts until the October 1987 Crash did away with that illusion which was immediately followed by hedge funds and derivatives as the sure thing of the 1990's.

If there is a "New World Order," it is in finance and economics. It is driven by globalization, communications, and technology. And, because it is huge and new, it is quite unpredictable and should be approached with care and humility. The current arguments as to the tradeoffs of growth, unemployment, and inflation are a good example of conventional assumptions. Where is the empirical evidence that 6 percent unemployment is the lowest tolerable level of unemployment without danger of inflation? Does anyone know how much capacity has really been added to the U.S. economy after 10 years of dramatic restructuring and downsizing? What is the impact of foreign competition and wage rates on U.S. costs? No one really knows, but every statement and every statistic has a tremendous impact on the financial markets as long as a so-called "expert" is the source.

There are too many uncertainties in the new world and too many dangers. A financial crisis, once started, is more and more difficult to stop. Monetary policy alone cannot deliver growth, low-interest rates, and a strong dollar when the world markets say otherwise. In order to be safe, we have to do what is in our control as much as possible: Reduce our borrowing requirements, strengthen the dollar, and lower interest rates to reduce the pressure on the capital markets. This can only be done with sustained and continued reduction in the budget deficit; this is no time for any type of tax cut whatsoever. The key to this effort could be the success of the Kerrey-Danforth Commission in making long-term inroads on entitlement spending. A credible 5-year plan coming out of that commission, which would bring the expense side of the budget into balance and providing for a separate capital budget, would have a very positive impact on all these variables. Allowing the financial bubble to get bigger will only cause a greater problem at some point in the future.

The recent volatility of securities markets here and abroad is a warning that while huge amounts of capital, some of it highly speculative are overpowering the world financial system, our arrangements for protecting that capital are inadequate. So are arrangements for raising the capital that the developing countries will urgently need. We are now nearing the fiftieth anniversary of the institutions created by the Bretton Woods Agreements—The World Bank and the IMF. It is time to review the structure of the world's financial system not only to increase its potential for raising living standards but to reduce the risk of enormous damage from a breakdown that could not be locally contained. In the meantime, we should do what is in our control to reduce those risks and improve our position; we should continue to reduce our deficit, reduce our borrowing needs, and protect the dollar.

PREPARED STATEMENT OF LEO MELAMED

Chairman and Chief Executive Officer, Sakura Dellsher, Inc.

Chairman Emeritus, Chicago Mercantile Exchange

September 28, 1994

Mr. Chairman and Members, I welcome the opportunity to appear before this Committee to address the condition of the United States capital markets, and issues arising from the globalization of world capital markets. My testimony will touch on four central themes that are interconnected and critical to the future strength and economic success of the United States in the next century: (1) The New World Financial Order; (2) The Telecommunications Revolution; (3) The Information Superhighway; and (4) The Pacific Era in the 21st Century.

The New World Financial Order

Allow me to begin by stating the obvious. Today is no ordinary moment in financial history. We have entered a unique financial order—this is the first time in modern history of mankind that virtually every country on the planet has a market-oriented economic system and is a competitor in the global marketplace. As David Hale, Chief Economist for Kemper Financial Services, points out, for the past 20 years when we spoke of globalization and of a global economy, we were really only speaking about 25 percent of mankind—mostly North America, Western Europe, and Japan. As recently as 6 years ago almost 70 percent of the human race was living under Marxist or socialist economic systems. Now, suddenly there are three billion additional participants in the Capitalist system.

Some of the primary factors that have combined to produce the new world financial order that is upon us include: (a) The collapse of Communism and the acceptance of market-oriented economics by a majority of nations; (b) The telecommunication revolution which brought us into the information age; (c) Computer technology which produced the ability to hedge financial exposure by virtue of both exchange-traded and OTC derivatives; (d) An overwhelming expansion of securitized forms of credit outside the banking system. In the United States, for instance, there are active secondary markets for commercial paper, corporate bonds, mortgages, credit card loans, and other forms of debt; (e) The sweeping internationalization of the trading of currencies, bonds, and equities; (f) A striking shift toward institutionalization of portfolio investment; and (g) A worldwide explosion of budgetary deficits.[1]

As a consequence of the foregoing, growth opportunities around the world are staggering. For example, the explosive growth of stock market capitalization in the developing countries since the late 1980's has opened the door to far larger private capital flows to these countries than at any time since the 19th Century. This is creating the potential for the most broadly-based global economic upturn since the industrial revolution.[2] However, please don't read this to mean that I am bullish on the U.S. stock market. Indeed, quite the contrary! As my testimony will explain, there may not be enough money around to finance our bull market and worldwide economic growth.

The United States is not only competing for market share and capital with *industrial* nations, but also with *emerging* nations. Just 5 years ago, emerging countries were capital exporters, whereas by 1993, emerging nations had capital inflows of almost $110 billion. The rebirth of developing nations' stock markets has already had a positive impact on their ability to import capital and boost their rates of investment growth. International capital flows to emerging country stock markets shot up to $52 billion during 1993 from less than 4 billion 5 years back. Since 1987, the market capitalization of the 25 countries included in the International Finance Corporation's Composite emerging market index has grown from $185 billion to $1.3 trillion. There are also another two dozen emerging dozen markets in eastern Europe and Africa with a market capitalization now approaching $100 billion. Developing countries also have improved their access to global bond markets. In 1993, they were able to sell $84 billion of bonds in the international capital market compared to only $28.6 billion in 1990.[3]

The expansion of stock markets in the developing countries since 1988 has been significant in both absolute terms and relative to the size of their economies. In the early 1980's, most Latin American countries had stock market capitalizations equal only to 5–10 percent of GDP whereas today they often have market capitalizations equivalent to 50–100 percent of GDP. Before the 1990's, the only East Asian countries which had large stock markets were former British colonies (Malaysia, Singapore) and Hong Kong. Today, by contrast, there are stock markets with values approaching 100 percent of GDP in Thailand, Taiwan, Indonesia, and Korea.

Moreover, governments in the new market-oriented economies have been promoting capital flows through security markets by liberalizing restrictions on foreign investment and privatizing State-owned enterprises. As a result of the initial success of countries such as Mexico with asset privatizations, the volume of privatizations in the developing countries has expanded from $2.6 billion in 1988 to $23 billion

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[1] Henry Kaufman, "Financial Derivatives in a Rapidly Changing Financial World," London, England, 14 October 1993.

[2] David Hale, "Global Economic Integration After the Cold War or How Will the Economic Order Created at Bretton Woods Adjust to Three Billion New Members," September 1994.

[3] *Ibid 2.*

in 1992. Privatizations also has helped to encourage a return of the flight capital which left Latin America during the 1980's debt crisis.[4]

Thus, as I stated at the outset, we have entered a unique world order that will place competitive stresses on the United States, its financial system and capital markets, such as we have never before encountered. To be prepared for the effects and implications this new financial era, we must first of all be aware and alert to this reality.

The Telecommunications Revolution

Of all of the factors that combined to usher in the new financial order, none were more influential than the technological revolution of the past several decades. This should come as no surprise. As it has throughout the history of man, technology has once again dictated fundamental and revolutionary change in our social structure and reshaped both the political and economic landscape of our planet.

In the political realm, modern telecommunications provided citizens the ability to judge their governments, compare their economic systems, examine their moral codes, scrutinize their cultural freedoms, and weigh them against those of other nations. Governments could no longer hide the truth from their citizens. As a result, the technological revolution of the last decades brought an end to the Communist regime, collapsed the Berlin Wall, and abolished the immoral walls of Apartheid. However, the effects of the information revolution extend beyond social and political change. As Dr. Carver Mead of the California Institute of Technology points out: "The entire Industrial Revolution enhanced productivity by a factor of about a hundred, but the microelectronic revolution has already enhanced productivity in information-based technology by a factor of more than a million—and the end isn't in sight yet." Clearly, the consequences of the telecommunications revolution will be felt in every facet and niche of civilized life, and—of particular note to this Committee—it has dramatically changed the nature and structure of capital markets.

As Milton Friedman succinctly stated, the technological revolution has made it possible for a company located anywhere in the world to use resources located anywhere in the world, to produce a product anywhere in the world, to be sold anywhere in the world. It is no longer necessary to use local resources to produce local products, locally. The fact that labor anywhere could cooperate with labor anywhere else had dramatic effects even before the political revolution. It meant that there was a large supply of relatively low-wage—but not necessarily low-skilled labor—to cooperate with capital from the advanced countries, capital in the form of physical capital, but perhaps even more important, capital in the form of human capital—of skills, of knowledge, of techniques, of training. Even before the political revolution, this international linkage of labor, capital, and know-how resulted in a rapid expansion in world trade which grew much more rapidly than income in the various countries and led to the growth of multi-national companies.[5]

Indeed, technological advancement, particularly in computer science unleashed forces that produced profound transformations in every component of civilization—from science to finance. It should therefore not be surprising that computer science was also the driving force behind the phenomenal growth of financial derivatives—which have gained such recent prominence in the news. To be more specific, computer technology has moved the world from the big to the little, from the vast to the infinitesimal.

In physics, for instance, we moved from General Relativity to quantum physics, and in biology from individual cells to gene engineering. The world's first understanding of the atom was simply as a solid central nucleus surrounded by tiny orbiting electrons. However, new computer technology brought a much clearer comprehension of the complexity of the atom, its subatomic particles of electrons, protons, and neutrons, and its nucleus containing intricate combinations of quarks. Similarly, in biology, technological advancements taught us that cells, originally thought to be simple repositories of chemicals, are more like high-tech factories in which complex chemical reactions produce substances that travel via networks of fibers.[6]

In markets, the evolution was strikingly similar. When advancements in computer technology were applied to established investment strategies, the result was remarkable. Just as it did in the sciences, market applications went from macro to micro. Intricate calculations and state-of-the-art analytical systems ensued, offering financial engineers the ability to divide financial risk into its separate components.

[4] *Ibid 2*

[5] Milton Friedman, "The Second Industrial Revolution," Remarks, The Fraser Institute 20th Anniversary, 18 May 1994.

[6] Tom Siegfried, "Discoveries," *Dallas Morning News*, 14 December 1992.

Derivatives—the financial equivalents to particle physics and molecular biology—were born. Consequently, investment methodologies were transformed from all-encompassing traditional strategies to finely tuned modern portfolio theories, and long-term hedging evolved into on-line risk management. In finance, this process was initiated by the financial futures revolution in the early 1970's when the International Monetary Market was launched at the Chicago Mercantile Exchange with the express intent of developing futures trade in financial products. This innovation created the first broad-based risk management instruments and ushered in the Era of Financial Futures. Thereafter, evolution in world economies transformed these relatively simple tools into the present genre of complex derivatives. Simple futures contracts in foreign exchange, Eurodollars, and bonds have evolved into complex swaps and swaptions, strips and straps, collars and floors.

Make no mistake. Government officials who are now wrestling with the problems posed by the Age of Derivatives and other market innovations will find, that it is nearly hopeless and counter-productive to attempt to harness their growth, prevent their invention, or regulate their application. Indeed, the arguments voiced about the risks in derivatives echo the fears expressed about molecular biology. And just as the U.S. Congress found it impossible to direct the developments in gene engineering, it will learn that financial engineering is equally unstoppable. In our global market environment—an environment driven by instantaneous information flows and sophisticated technology—the ingenuity and creativity of physicists, biologists, scientists of every class, and market participants will continue unabated—as will the Age of Derivatives. That is not to imply that derivatives pose no risks. Indeed they do, but are best attended to by the private sector. The U.S. Congress should do its part by encouraging dealers and end-users to prescribe and adopt recognized internal controls.

The Information Superhighway

Indeed, the rate of technological innovation will continue to accelerate. If the United States does not keep pace, our financial service sector, as well as our industrial structure will be left behind. This reality is no longer some idle threat. It has led this Administration to correctly direct our national efforts toward the "Information Superhighway." The information highway—the nomenclature for an evolution that will unfold over the next decade or so—represents the convergence of computer, telephone, and television technologies into networks that provide access to everything from the telephone to television to electronic textbooks at the touch of a button.

Unfortunately, as recently as last week, a sweeping effort to rewrite the U.S. telecommunications laws to permit open competition between telephone and cable-television companies collapsed in the Senate amidst feuding between rival industry groups. Failure of the bill, announced by its chief Senate sponsor Senator Ernest F. Hollings of South Carolina, came despite a broad consensus that current laws have not kept pace with changes in technology and despite strong bipartisan support for the legislation. Notwithstanding the extraordinary efforts of top lawmakers in both the House and the Senate to hammer out the necessary compromises, the bill collapsed. Had it passed, the bill would have overhauled the 60-year-old American communications laws from top to bottom. Its primary goal was to eliminate the regulatory barriers that divided the industry into separate and protected fiefdoms for local telephone, long distance, and cable television service. To succeed in the 21st Century, our Nation must do better than that.

Indeed, during the same week, telecommunications ministers from nearly fifty countries met in Kyoto, Japan, to declare that the early construction of a global information superhighway was critical to achieving balanced economic growth over the next century. The meeting is likely to have a significant impact on the Group of Seven industrialized nations meeting set for next February to discuss a global information network. The Kyoto communique emphasizes the desirability of developing superhighway infrastructures on a global basis to provide advanced information and communications services to every country and region. Information will become increasingly more important for economic activity, particularly as the implementation of the Uruguay Round agreement makes the flow of goods and service increasingly smooth. It is critical for the United States to maintain its leadership in this telecommumcations race. Allow me to underscore the Vice President's point: The information infrastructure is to the U.S. economy of the 1990's what transport infrastructure was to the economy of the mid-20th Century.

Allow me to quote the Vice President of the United States: "The linking of the world's people to a vast exchange of information and ideas is a dream that technology is set to deliver. President Clinton and I believe that the creation of a network of networks, transmitting messages and images at the speed of light across

every continent, is essential to sustainable development for all the human family. It will bring economic progress, strong democracies, better environmental management, improved health care, and a greater sense of shared stewardship of our small planet. To this end, legislators, regulators, and business people must now build and run a Global Information Infrastructure (GII)."[7]

Our national lawmakers must particularly cognizant of the fact that the advances in digital telecommunications technology, fiber optics, and new high-capacity satellite systems are transforming world telecommunications. A fiber optic cable can carry thousands of telephone calls per second over a single strand of glass. In 1966, the best transatlantic cable could simultaneously carry only 138 conversations between Europe and North America. The first fiber optic cable, installed in 1988, could carry 40,000, and today's cables can transport nearly 1.5 million.[8] In the past, it could take years to build a network. Today, a single satellite and a few dozen ground stations can be installed in a few months.

Information infrastructure is one way in which the United States can maintain its economic lead. Not only do we innovate, create, develop, and export equipment such as telecommunications equipment—cellular phones, PBX systems, portable phones, radios, satellites, modems, computers, network hardware and software, scanners, faxes, and so on—but we also lead in the application of these technologies. U.S. companies are exploring the possibilities of interactive merchandising—the marriage of merchandising and cable communications using computers, telephones, and fax machines, and networks with merchandisers, manufacturers, and banks. Banks will expand their financial services through the use of the information highway: People will be able to check their balances, to transfer money, much as businesses do today, but on a worldwide scale.

Technological advances combined with the elimination of official barriers to capital flows in cross border financial transactions and activities have served to advance the cause of capitalism. Our Government needs to advance this trend and foster an environment that will help, not hinder, this process. Internet is a perfect example of Government doing something correctly. Internet was devised some 30 years ago during the Cold War, when the Government—worried that a nuclear war would paralyze all communications—developed a computer network capable of reaching far-flung terminals even if many connections were severed. In 1969, the Pentagon finally built this network. It was quickly subverted to another use—electronic mail—and fortunately the Government ruled lightly, allowing it to grow. The result today is Internet, a mass of interconnected networks.

The U.S. Congress can assist in the development of technology and standards by working with industry to ensure that messages and services have the ability to flow seamlessly among hundreds of proprietary networks. If there are too many disparate technologies, people will stop investing and stop buying. That means cooperating not only in ways which affect the technology but in cooperating with other Governments and world financial organizations. We need to assist in the creation of widely-accepted accounting practices, encourage practices such as netting, and assist in creating banking standards to ensure the stability of the world financial system. Moreover, Government should deregulate communications and encourage the conversion to digital. Broader access to these technologies is best achieved by permitting vital, competitive, aggressive industries to compete. The net effect is greater access of superior goods to more people at a lesser cost.

Unfortunately Government does not always abide by this role. According to Milton Friedman, in addition to direct Government expenditures, there are regulations and rules that Government imposes which essentially mandate expenditures by private individuals or control the uses to which they may put their property or the income from it. Even a conservative estimate of the costs imposed upon the community by those regulations raises the total fraction of the property of the United States that is in effect owned by the Government—Federal, State, and local, to more than 50 percent. In Professor Friedman's view what we are doing in the United States is preaching capitalism and practicing socialism.

Although it is superfluous to say it, it must be emphasized: As we enter the 21st Century, it is imperative that the United States do its utmost to preserve its top ranking in the global economic order. This will require new skills and competencies, not only in terms of technology, but also in manufacturing and in learning new ways of conducting business. Whereas in the past the United States dictated the terms by which business was conducted, the burgeoning markets in Asia and Latin Amer-

[7] Vice President Al Gore, "Plugged into the World's Knowledge," *Financial Times*, 19 September 1994, p. 17.

[8] Nathan Rosenberg, "Inventions: Their Unfathomable Future," *The New York Times*, 7 August 1994.

ica necessitate that we be more sensitive to their ways of conducting business. In the future, the U.S. may no longer be the arbiter of business methods. The foregoing is of particular relevance with respect to our current policies pertaining to Japan and China. This leads me to the final point.

The Pacific Era in the 21st Century

John Hay, the American Secretary of State at the turn of this century, said it well: "The Mediterranean is the ocean of the past, the Atlantic the ocean of the present, and the Pacific the ocean of the future." Make no mistake, the future of the Pacific era has arrived. Today, the countries of the Pacific Rim represent a combination of developed and developing nations that jointly embody an economic force equal to any region of the world. "Today," states John Naisbitt, in his *Megatrends 2000,* "the Pacific Rim is undergoing the fastest period of economic expansion in history, growing at five times the growth rate during the industrial revolution."

The geographic area involved is as large as it is diverse. By its all-inclusive definition, it accounts for two-fifths of the world's surface and nearly half of the world's population. It is the geographical region with the potential of becoming the world's leading market force in the 21st Century. With a population ten times greater than North America, six times greater than Europe, and a faster growth rate than either region, Asia has the potential to overtake the other two regions economically before very long. Last year, for instance, transpacific trade exceeded trade across the Atlantic by 50 percent; in 5 years, the ratio could be 2-to-1 in favor of the Pacific.[9]

Japan is, of course, the financial colossus of region encompassing a vast and complex business infrastructure. Australia and New Zealand provide the anchor on the South. Australia, almost as large as the continental United States, is more British than Asian but its location makes it imperative for the continent to think Asian. The newly industrialized countries, include Singapore, Hong Kong, South Korea, and Taiwan. Hong Kong, of course, will revert to China in 1997 and become a uncommon segment of this vast and underdeveloped giant. Then there are the members of the Association of South East Asian Nations, which include Indonesia, Malaysia, the Philippines, and Thailand. When you then add the vast land mass of mainland China itself with its additional billion people, you begin to grasp the magnitude of the potential this geographic area and why we must regard the coming millennium as the Pacific Era.

Not much more need be said. Only if we are blind to the foregoing reality will we miss the opportunity it represents. To take full advantage of the political and economic revolutions that have occurred in this region, to take full advantage of the potential it represents, we must open our borders and facilitate international trade. Only in this fashion can we make it possible to capitalize on the human capital that is available in this region in order to cooperate with U.S. more highly skilled human capital, and with our physical capital—to the benefit of both our regions.

The United States remains the overwhelming symbol of freedom, democracy, economic success, and opportunity to the people of Asia. We must nurture this view and build bridges of friendship, coordination, and economic cooperation. We dare not miss this historic opportunity. Our most fatal mistake would be to adopt short-sighted policies in favor of protectionism—the scourge of markets everywhere. The consequences of protectionism are as devastating as they are ubiquitous. Particularly as it relates to the Asian world, we dare not allow the global triumph achieved in recent years by free markets, primarily by virtue of American leadership and expense, to be wasted. We dare not allow the new financial world order we have fought so long and so valiantly to achieve to be derailed, deterred, or defeated. Here at the dawn of the 21st Century, we dare not allow defeat to be snatched from the jaws of victory that our Nation and its citizens so justly deserve.

[9] Bruce Clark, "Europe in the Pacific Century," *Financial Times,* 19 September 1994.

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